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Supreme Court of the United States

A&F TRADEMARK, INC.; CACIQUECO, INC.; EXPRESSCO, INC.; LANCO, INC.; LERNCO, INC.; LIMCO INVESTMENTS, INC.; LIMTOO, INC.; STRUCTURECO, INC.; AND V. SECRET STORES, INC.,

Petitioners,

v.

E. NORRIS TOLSON, SECRETARY OF REVENUE, STATE OF NORTH CAROLINA,

Respondent.

On Petition For A Writ Of Certiorari To The North Carolina Court Of Appeals

PETITION FOR A WRIT OF CERTIORARI

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QUESTION PRESENTED

Whether *Quill Corp. v. North Dakota's* Commerce Clause nexus test forbidding taxation in the absence of physical presence applies to all State taxes – as held by decisions in Michigan, New Jersey, New York, Tennessee, Texas and West Virginia – or – as the North Carolina decision below held, and as also concluded by decisions in Illinois, Kentucky, Maryland, Massachusetts, New Mexico, Ohio, South Carolina and Washington – whether the rule applies only to State sales and use taxes.

LIST OF PARTIES

The parties are as stated in the caption.

RULE 29.6 STATEMENT

Limited Brands, Inc., a publicly traded company, indirectly owned more than 10 percent of the stock of each of the petitioners during the year at issue and retains the right to pursue the instant case which involves only the assessments of North Carolina income and franchise taxes for the fiscal year ended January 31, 1994.

Caciqueco, Inc. was dissolved into another indirectly owned subsidiary of Limited Brands, Inc., Intimate Beauty Corporation, on January 28, 2000, and Structureco, Inc. was merged into Express LLC, another indirectly owned subsidiary of Limited Brands, Inc., on December 12, 2003.

Subsequent to the year at issue, Limited Brands, Inc. divested itself of its indirect ownership interest in several of the other petitioners as follows: A&F Trademark, Inc. on May 18, 1998, Lanco, Inc. on August 16, 2001, Lernco, Inc. on November 27, 2002 and Limtoo, Inc. on August 23, 1999. Limited Brands, Inc. is not aware of whether the petitioners in which it no longer retains an indirect ownership interest remain in existence or, if still in existence, whether they are currently owned by publicly traded companies, but they do not retain any independent legal interest in the tax assessments at issue in this case.

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PETITION FOR A WRIT OF CERTIORARI

Petitioners respectfully seek this Court's review of the judgment of the North Carolina Court of Appeals.

OPINIONS BELOW

The opinion of the North Carolina Court of Appeals (App. A at 1a-21a), dated December 7, 2004, is reported at 605 S.E.2d 187. The order of the North Carolina Superior Court, Wake County (App. B at 22a-23a), dated May 22, 2003, is not reported. The decision of the North Carolina Tax Review Board (App. C at 24a-76a), dated May 7, 2002, is not reported. The Final Decision of the Assistant Secretary of the North Carolina Department of Revenue (App. D at 77a-199a) was issued on September 19, 2000, and is not reported.

JURISDICTION

The decision of the North Carolina Court of Appeals was rendered on December 7, 2004 (App. A at 1a). The North Carolina Supreme Court denied petitioners' petition for discretionary review by Order entered on March 7, 2005 (App. E at 200a-202a). The North Carolina Court of Appeals issued an Order, dated March 17, 2005, certifying to the Clerk of the Superior Court, Wake County, that the North Carolina Supreme Court allowed the Motion to Dismiss the Appeal and denied the Petition for Discretionary Review (App. F at 203a-204a). The jurisdiction of this Court rests upon 28 U.S.C. § 1257(a).

CONSTITUTIONAL, STATUTORY AND REGULATORY PROVISIONS INVOLVED

The Commerce Clause of the United States Constitution, U.S. Const. Art. I, § 8, cl. 3, provides: "The Congress shall have Power . . . [t]o regulate Commerce with foreign Nations, and among the several States, and with the Indian Tribes."

The relevant portions of the North Carolina statutes and the relevant regulation are set forth at App. G at 205a-208a.

STATEMENT

The question of whether the Constitution permits a State to impose a tax upon an entity that lacks physical presence in that State is an issue of paramount importance. Many courts and tax tribunals believe this Court resolved the issue – for all taxes – in *Quill Corp. v. North Dakota,* 504 U.S. 298 (1992). In *Quill*, this Court concluded that *National Bellas Hess, Inc. v. Department of Revenue of Illinois*, 386 U.S. 753 (1967), remained good law, and that the substantial nexus required under the Commerce Clause between a State and an entity that it taxes means that the taxed entity must have some physical presence in the State. Certain States – including North Carolina here – have limited the application of *Quill's* physical presence requirement, however, to only sales and use taxes. They have applied another, broader rule to income and franchise taxes, requiring only an economic nexus that is predicated upon the mere derivation of income from in-state sources.

By the decision below, the North Carolina Court of Appeals reverted to a pre-*Quill* analysis for income and franchise taxes, adopting the Due Process minimum contacts standard and thereby eviscerating this Court's reasoned differentiation between Commerce Clause and Due Process requirements and excising the "substantial" from "substantial nexus." In *Quill*, this Court explained that the Due Process and Commerce Clause "standards are animated by different constitutional concerns and policies," 504 U.S. at 312, and that the "concerns about the effects of state regulation on the national economy" under the Commerce Clause support a higher "substantial nexus" standard under the Commerce Clause than applies under the Due Process Clause.

A. The Facts

At all times relevant to the North Carolina tax assessments at issue in this case, petitioners were Delaware corporations headquartered and located in Delaware. They were incorporated over a period of years beginning in 1980. Petitioners were formed by, and were wholly-owned subsidiaries of, The Limited, Inc., currently, Limited Brands, Inc., an Ohio-based corporation. Limited Brands is engaged in the nationwide retail sale of clothing and accessories through its retail operating subsidiaries.

Petitioners were each formed to protect and manage trademarks, service marks and trade names (their "marks") and had no physical presence in North Carolina. None of the petitioners had offices, employees, real property or tangible personal property in North Carolina.

Once petitioners were created, they licensed their marks under non-exclusive licenses to the retail operating

subsidiaries of Limited Brands on an arm's length basis. The license agreements did not require that the retailers use the marks in any particular jurisdiction. As a direct result of the management of the marks by petitioners, the marks were successfully protected throughout the world. Each of the petitioners, in addition to licensing its marks, also earned income from loaning money to its affiliated retailer.

Numerous business and legal reasons motivated Limited Brands to establish the separate petitioner companies to own and protect the marks, including: (1) provision of a centralized system to deal with the marks on a worldwide basis, which eases the business' entry into international licensing and retailing; (2) protection of the U.S. retail operations, and the officers and directors, from being harassed in litigation, particularly outside the United States; and (3) protection from hostile takeovers. Avoiding taxes was *not* a motive in deciding to establish the trademark protection companies, although tax considerations were weighed in deciding where to locate the companies.

B. The Assessments

The North Carolina Department of Revenue asserted that petitioners are liable to the State for corporate income and franchise taxes for the fiscal years ended January 31, 1992 through January 31, 1994. Inclusive of interest and penalties, the proposed income tax assessments total $4,684,830 and the proposed franchise tax assessments total $308,852.

C. The Decisions Below

1. Petitioners filed an application for hearing before respondent, the North Carolina Secretary of Revenue, to protest the proposed assessments. An administrative tax hearing was held at which several expert witnesses testified and submitted reports detailing their findings. Professor Richard D. Pomp, renowned in the state and local tax community, testified as an expert witness in state tax policy, analysis of state tax distortion, factor analysis and state tax accounting. He concluded that, "[b]y any principled measure of comparison, physical presence is preferred to metaphysical presence as a nexus standard." (App. H at 223a.) He also concluded that the metaphysical presence, *i.e.*, economic nexus concept might actually result in lower tax revenue for the State of North Carolina. (App. H at 223a.)

Petitioners also presented expert testimony from two economists, David Baumer, associate professor in the Department of Business Management at North Carolina State University, and David Wildasin, Professor of Economics at Vanderbilt University, concerning the economic invalidity of the economic nexus concept advocated by the State Department of Revenue and ultimately accepted by the North Carolina Court of Appeals. Professor Baumer testified that assertion of a nexus adequate for State taxation without any requirement of physical presence in the State would lead to considerable interference with interstate commerce. He also testified that requirement of physical presence in the State is unambiguous and consistent with the economic expectations of businesspeople and academic observers, and avoids the unnecessary expenditure of resources. (App. J at 272a.) Professor Wildasin testified that it is undesirable on economic grounds for

states and localities to tax entities that are not physically present in those jurisdictions. A corporation whose only connection is through the licensing of intangible assets does not impose on a State costs for the provision of any public services and, therefore, should not share in those costs by payment of income taxes. Requiring such out-of-state corporations to pay taxes to a State creates adverse economic incentives, and would harm national economic performance. (App. I at 242a-243a.)

Although the Assistant Secretary presiding over the hearing understood that "it is well-settled that the Secretary cannot rule on the constitutionality of a statute," he nonetheless concluded, in *dicta*, that *Quill's* physical presence standard should be rejected due to the changing national commercial landscape. The Secretary entered an order abating all penalties asserted against petitioners, but sustained the imposition of the taxes for one of the three years, the fiscal year ended January 31, 1994, in a Final Decision entered on September 19, 2000. (App. D at 77a-199a.)

2. Petitioners filed a Petition with the North Carolina Tax Review Board to review the Secretary of Revenue's Final Decision. The Tax Review Board confirmed the Final Decision, but did not address petitioners' constitutional arguments under *Quill* because it lacked the authority to do so. (App. C at 75a-76a.)

3. Petitioners appealed the decision of the Tax Review Board to the Wake County Superior Court. The Superior Court affirmed the Tax Review Board's decision and held, without explanation, that the decision was "not in violation of constitutional provisions." (App. B at 23a.)

4. The North Carolina Court of Appeals affirmed. (App. A at 1a-21a.) The court concluded that the physical presence requirement to meet the "substantial nexus" test under the Commerce Clause for a State's imposition of sales and use taxes does not require physical presence in a State of an entity as a prerequisite to the State's authority to impose franchise or income taxes on that entity. The court rejected petitioners' argument that the Commerce Clause standards apply equally to all taxes, stating that petitioners' argument was a "broad reading of *Quill*." (App. A at 14a.) The Court of Appeals reasoned that (1) this Court has not applied the physical-presence requirement of *Quill* to taxes other than sales and use taxes; (2) the *stare decisis* concerns which motivated this Court to retain the physical presence standard in *Quill* are not present here; and (3) sales and use taxes are different from franchise and income taxes and those distinctions make physical presence an "inappropriate" nexus standard for franchise and income taxes. (App. A at 15a-16a.) The court also rejected various arguments regarding interpretations of State law. (App. A at 17a-20a.)

5. The North Carolina Supreme Court denied petitioners' petition for discretionary review on March 3, 2005; the Order was entered on March 7, 2005. (App. E at 200a-202a.)

REASONS FOR GRANTING THE PETITION

I. DECISIONS RENDERED IN SEVERAL STATES ARE IN CONFLICT REGARDING THE CONSTITUTIONAL LIMIT ON IMPOSITION OF STATE FRANCHISE AND INCOME TAXES, AND RESOLUTION OF THE CONFLICT IS CRITICAL FOR INTERSTATE BUSINESSES TO OPERATE EFFECTIVELY

A. Several States Disagree on the Applicability of the Physical Presence Requirement of *Quill* to Franchise and Income Taxes

The North Carolina Court of Appeals expressly recognized that its ruling in this case is directly contrary to the decision of the New Jersey Tax Court in a case involving one of the very same businesses involved in this case. (App. A at 18a-19a (citing *Lanco, Inc. v. Director, Division of Taxation*, 21 N.J. Tax 200 (2003) (appeal pending)).) The New Jersey Tax Court rejected the argument of the Division of Taxation that it could impose the State's corporation business tax on the company on the sole basis that the company received income from the use of its intangibles in New Jersey. *Lanco, Inc. v. Director, Div. of Taxation*, 21 N.J. Tax 200 (Tax Ct. 2003) (appeal pending). But the court below "respectfully disagree[d]" with that ruling, noting the division with other courts. (App. A at 18a.)

A review of the decisions rendered by the various State courts and tax tribunals since this Court's decision in *Quill Corp. v. North Dakota*, 504 U.S. 298 (1992), confirms that North Carolina is not alone in its erroneously constricted view of the taxes to which *Quill's* physical presence requirement applies. The volume of case law also establishes that businesses and governmental entities

have been embroiled in costly, time-consuming litigation which, given the high financial stakes, will continue unabated until this Court resolves this crucial issue presented here.

In decisions directly contrary to that of the North Carolina Court of Appeals in this case, Michigan, New Jersey, New York, Tennessee, Texas and West Virginia have rejected attempts by their State departments of revenue to impose taxes merely on the basis of receipts derived from in-state sources, and have held that this Court's decision in *Quill* precludes a State from imposing franchise or income taxes on an entity that does not have a physical presence in the State. *See Guardian Indus. Corp. v. Department of Treasury*, 198 Mich. App. 363, 499 N.W.2d 349 (1993), *appeal denied sub nom. Cargill, Inc. v. Department of Treasury*, 444 Mich. 934, 512 N.W.2d 846 (1994); *Lanco, Inc. v. Director, Div. of Taxation*, 21 N.J. Tax 200 (Tax Ct. 2003) (appeal pending)[1]; *In re Wascana Energy Mktg. (U.S.), Inc.*, DTA No. 817866 (N.Y.S. Div. of Tax Appeals, Aug. 8, 2002); *J.C. Penney Nat'l Bank v. Johnson*, 19 S.W.3d 831, 839 (Tenn. Ct. App. 1999), *cert. denied*, 531 U.S. 927 (2000); *Rylander v. Bandag Licensing Corp.*, 18 S.W.3d 296 (Tex. App. 2000); *MBNA Am. Bank, N.A. v. Steager*, Nos. 03-185 RN, 03-186 RFN, 04-074 RFN, 04-075 RN (W. Va. Office of Tax Appeals Oct. 22, 2004).

At the same time, decisions rendered in Illinois, Kentucky, Maryland, Massachusetts, New Mexico, Ohio, South Carolina and Washington have concluded that the

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[1] *See also Home Impressions, Inc. v. Director, Div. of Taxation*, 21 N.J. Tax 448, 456 n.13 (Tax Ct. 2004) (finding "no reason to conclude that a franchise tax should be analyzed in a different manner [from use tax situations], [the Tax Court] will apply the standard in *Quill*").

physical presence requirement for "substantial nexus" under the Commerce Clause applies only to determine nexus in cases involving sales and use taxes. *See Borden Chems. & Plastics, L.P., v. Zehnder,* 312 Ill. App. 3d 35, 726 N.E.2d 73, *review denied*, 189 Ill. 2d 656, 731 N.E.2d 762 (2000); *Annox, Inc. v. Revenue Cabinet*, No. K-19039 (Ky. Bd. of Tax Appeals Nov. 18, 2003) (*dicta*), *aff'd,* No. 03-CI-1605 (Franklin County Cir. Ct. Feb. 17, 2005) (affirming decision; omitted *dicta*); *SYL, Inc. v. Comptroller,* 375 Md. 78, 825 A.2d 399, *cert. denied,* 540 U.S. 984 (2003); *Truck Renting & Leasing Ass'n v. Commissioner of Revenue*, 433 Mass. 733, 746 N.E.2d 143 (2001) (*dicta*); *Kmart Props., Inc. v. Taxation & Revenue Dep't of N.M.,* No. 21,140 (N.M. Ct. App. Nov. 27, 2001), *cert. granted and submitted,* No. 27,269 (N.M. Oct. 14, 2004) (not precedential); *Couchot v. State Lottery Comm'n,* 74 Ohio St. 3d 417, 659 N.E.2d 1225 (*dicta*), *cert. denied*, 519 U.S. 810 (1996); *Geoffrey, Inc. v. South Carolina Tax Comm'n,* 313 S.C. 15, 437 S.E.2d 13, *cert. denied,* 510 U.S. 992 (1993); and *General Motors Corp. v. City of Seattle*, 107 Wash. App. 42, 25 P.3d 1022 (2001), *cert. denied*, 535 U.S. 1056 (2002).

The division among States around the country on this issue could not be clearer. Indeed, the courts within some States have even reached conflicting conclusions with one another. *Compare Geoffrey, Inc. v. South Carolina Tax Comm'n,* 313 S.C. 15, 18, 437 S.E.2d 13, 15 (holding that "any corporation that regularly exploits the markets of a state should be subject to its jurisdiction to impose an income tax although not physically present"), *cert. denied*, 510 U.S. 992 (1993), *with City of Charleston v. Government Employees Ins. Co.*, No. 93-CP-10-2567 (S.C. Ct. C.P. Sept. 15, 1997) (concluding that physical presence is required in "cases involving taxes other than 'sales' or 'use' taxes"),

rev'd on other grounds, 334 S.C. 67, 512 S.E.2d 504 (1999). *Compare Dial Bank v. Alabama Dep't of Revenue*, Nos. INC. 95-289 & F. 95-308 (Admin. Law Div. Aug. 10, 1998); *Cerro Copper Prods., Inc. v. Alabama Dep't of Revenue*, No. F.94-443 (Admin. Law Div. Dec. 11, 1995) and *9.4% Manufactured Housing Contract Pass-Through Certificate Series 1989A v. Alabama Dep't of Revenue*, No. CORP. INC. 95-162 (Admin. Law Div. Dec. 11, 1995) *with Lanzi v. Alabama Dep't of Revenue*, No. INC. 02-721 (Admin. Law Div. Sept. 26, 2003) ("I am no longer convinced that the Supreme Court intended the *Quill* physical presence test to apply beyond sales and use tax.").

Rarely has such a fiscally significant issue been met with such little unanimity amongst the States. Rarely have so many States been so willing to interpret precedent in such a constrained manner in their zeal to garner revenue. Rarely has the need for this Court's intervention been as urgent.

B. The Disagreement Among the States is Disruptive to Interstate Commerce Because it Eliminates the Predictability and Clarity of the Various States' Taxing Authority

There is only one Commerce Clause and only one nexus requirement under the Commerce Clause regardless of the type of state tax imposed. All States must uniformly apply that law. At present, however, a business assessing whether physical presence in a State is required before it can be subjected to the State's income and franchise tax, will be faced with different conclusions in different States.

Tax nexus is too significant an issue to too many for predictability and clarity to be absent. Uncertainty inhibits business planning and investment and is extraordinarily costly from a fiscal and societal vantage point. While many problems of such magnitude are not easily addressed, this Court has the power and ability to ensure that the integrity of the judicial process is not eroded, reliance interests are respected, and the clarity provided by *Quill* is restored to this country's business community and tax agencies.

II. THE NORTH CAROLINA COURT OF APPEALS' DECISION CANNOT BE RECONCILED WITH THIS COURT'S PRECEDENT

The North Carolina Court of Appeals did not follow this Court's ruling in *Quill Corp. v. North Dakota,* 504 U.S. 298 (1992), that the Commerce Clause requires the physical presence of an entity in a State as a prerequisite to the State's exercise of its taxing authority. This Court has *never* found the Commerce Clause substantial nexus test to be met where the taxed entity did not have a physical presence in the State imposing the tax.

In *Quill,* this Court held that a mail-order business that had only a *de minimis* physical presence in North Dakota, yet derived substantial revenue from its mail-order sales to customers in that State, could not be required to collect and remit use tax to North Dakota on its sales to its North Dakota customers. The Court arguably left open the application of the rule outside of the sales and use tax arena, but the Court has never stated that there are different standards under the Commerce Clause based on the type of tax at issue. In *Quill*, this Court made two statements that have led States to argue that there

are different "substantial nexus" requirements under the Commerce Clause. The first was: "Although we have not, in our review of other types of taxes, articulated the same physical-presence requirement that *National Bellas Hess, Inc. v. Department of Revenue of Illinois,* 386 U.S. 753 (1967) established for sales and use taxes, that silence does not imply repudiation of the *Bellas Hess* rule." 504 U.S. at 314. The second was: "In sum, although in our cases subsequent to *Bellas Hess* and concerning other types of taxes we have not adopted a similar bright-line, physical presence requirement, our reasoning in those cases does not compel that we now reject the rule that *Bellas Hess* established in the area of sales and use taxes." 504 U.S. at 317.

Those statements do not compel rejection of the *Quill/Bellas Hess* standard for other taxes. Indeed, this Court's pre-*Quill* and post-*Quill* decisions consistently support the conclusion that the Commerce Clause's physical presence requirement under the "substantial nexus" test set forth in *Quill* and *Bellas Hess* applies equally to *all* manner of taxes. In *Complete Auto Transit, Inc. v. Brady,* 430 U.S. 274 (1977), a sales tax case, the Court relied equally on franchise tax precedent and that case has widely been regarded as setting forth the standard for income tax cases. *See, e.g. Mobil Oil Corp. v. Commissioner of Taxes of Vt.*, 445 U.S. 425 (1980); *Amerada Hess Corp. v. Director, Div. of Taxation,* 490 U.S. 66 (1989); *Trinova Corp. v. Michigan Dep't of Treasury*, 498 U.S. 358 (1991); *Barclays Bank PLC v. Franchise Tax Bd.*, 512 U.S. 298 (1994).

In *Complete Auto*, 430 U.S. at 274, the Court relied on franchise tax precedent *i.e., Colonial Pipeline Co. v. Traigle*, 421 U.S. 100, 101 (1975), and emphasized that

semantic differences between taxes should not result in different analyses or results under the Constitution, concluding that "[a] tailored tax, however accomplished, must receive the careful scrutiny of the courts to determine whether it produces a forbidden effect on interstate commerce." *Complete Auto,* 430 U.S. at 288 n.15 (Court noted that its four-prong analysis,[2] which includes the "substantial nexus" requirement, had been applied by the Court to "many types of tax", *id.* at 279); *Goldberg v. Sweet,* 488 U.S. 252 (1989) (tax on telephone calls); *Container Corp. of Am. v. Franchise Tax Bd.,* 463 U.S. 159 (1983) (franchise tax). In *Commonwealth Edison Co. v. Montana,* 453 U.S. 609, 626 (1981), this Court stated that "[u]nder this threshold test, the interstate business must have a substantial nexus with the State before any tax may be levied on it." It is evident that the substantial nexus test applies whether the tax is directly applied against a taxpayer, *e.g.*, franchise or income tax, or if the taxpayer merely has collection responsibilities, *e.g.*, sales or use tax.

In fact, this Court has suggested that, because of the risk of multiple taxation, a *higher* jurisdictional threshold should exist for the direct imposition of tax, such as income and franchise taxes, than for collection of use taxes. *National Geographic Soc'y v. California Bd. of Equalization,* 430 U.S. 551, 557 (1977). No decision of this Court supports application of a lower standard or a more

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[2] Under the four prong test set out by this Court in *Complete Auto* a tax will be sustained under the Commerce Clause only if the tax: (1) is applied to an activity with a substantial nexus with the taxing State; (2) is fairly apportioned; (3) does not discriminate against interstate commerce; and (4) is fairly related to the services provided by the State.

relaxed standard for income and franchise taxes than for sales and use taxes, nor is there anything in the plain language of the Commerce Clause that supports different standards. Application of the single Commerce Clause standard to all taxes, including income and franchise taxes, is not an unwarranted "expansion" (App. A at 14a), as the North Carolina Court of Appeals held, but is an internally consistent, time-honored, logical approach to the constitutional nexus requirement.

The lower court disregarded the impact of *Quill* on the basis that *Quill's* retention of *Bellas Hess* was grounded on the principle of *stare decisis* and on the substantial reliance on the physical presence test by the mail order industry, and the court below concluded that "[n]either consideration advocates for the [petitioners'] position." (App. A at 15a.) *Stare decisis* concerns, however, apply equally to corporations that have relied on this Court's holdings in *Quill* as their basis for not filing income and franchise tax returns in the jurisdictions where they lack physical presence. Indeed, unlike the situation in *Quill* which was focused upon one industry, the issue here extends to all entities that lack physical presence in a State, yet derive revenue from its residents.

Moreover, because the statute of limitations on a tax assessment does not begin to run until a tax return is filed, North Carolina General Statutes section 105-241(e), if North Carolina's decision is allowed to stand, all individuals and entities that receive income attributable to the use of their intangible property in a State would become subject to tax for each and every past year for which no tax return was filed in that State. Unlike use tax, which is imposed on the user of the intangible property, franchise and income taxes are direct taxes and these individuals

and entities would have no recourse to reimbursement from their customers. Thus, *stare decisis* is even more critical here than it was when this Court decided in *Quill* to adhere to its 1967 Commerce Clause precedent in *Bellas Hess*.

III. STATES HAVE BECOME EMBOLDENED BY THIS COURT'S FAILURE TO INTERCEDE IN STATES' REVENUE-DRIVEN DISREGARD FOR THE COMMERCE CLAUSE TO THE DETRIMENT OF OUT-OF-STATE OWNERS OF INTANGIBLE PROPERTY

A. The States' Growing Disregard for the Commerce Clause Limitations of *Quill*

Chief Justice Marshall correctly understood that the "power to tax involves the power to destroy." *McCulloch v. Maryland,* 17 U.S. 316, 431 (4 Wheat.) (1819). He observed that States would not "respect the interests of others" (*Brown v. Maryland,* 25 U.S. 419, 440 (12 Wheat.) (1827)) and that the Commerce Clause was necessary "[o]r what should restrain a State from taxing any article passing through it from one State to another, for the purpose of traffic? or from taxing the transportation of articles passing from the State itself to another State, for commercial purposes?" *Id.* at 449.

Quill was decided by this Court in 1992, affirming its *Bellas Hess* ruling that the Commerce Clause substantial nexus test requires physical presence in a State to support imposition of sales and use taxes. For the first time this Court recognized the distinction between the nexus requirements under the Due Process and Commerce Clauses. Nonetheless, in the following year, the South

Carolina Supreme Court issued its decision in *Geoffrey, Inc. v. South Carolina Tax Commission*, 313 S.C. 15, 437 S.E.2d 13, *cert. denied*, 510 U.S. 992 (1993), and ignored this distinction by holding that *Quill's* physical presence test does not apply to income and franchise taxes, relying upon pre-*Quill* state decisions that never recognized the distinction between the Due Process and Commerce Clauses. Since the South Carolina court's *Geoffrey* decision, several States have amended their statutes, promulgated regulations and issued other "authority" to limit *Quill's* holding to sales and use taxes.[3] The result is precisely the evil with which the framers of the Constitution were concerned – the shifting

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[3] For example, North Carolina's Department of Revenue promulgated Rule 5C.0102(a)(5)(C) of title 17 of the Administrative Code to expand its interpretation of "doing business" to include "the operation of any business enterprise or activity in North Carolina for economic gain, including ... the owning, renting or operating of business or income-producing property in North Carolina including ... [t]rademarks, tradenames, franchise rights, computer programs, copyrights, patented processes, [or] licenses." *See also* Ark. Reg. 1996-3 (licensing of intangibles in an intragroup intangible licensing transaction creates nexus); Fla. Admin. Code r. 12C-1.011 (selling or licensing the use of intangibles for years beginning after January 1, 1994 creates nexus); Iowa Admin. Code r. 701.52.1(422) (citing *Geoffrey* and providing that licensing intangibles to corporations doing business in Iowa creates nexus); Directive 96-2 (Mass. Dep't of Revenue July 3, 1996) (licensing of intangibles for use in Massachusetts creates nexus); Minn. Stat. § 290.015 (providing that business within Minnesota includes transactions with customers in the State that involve intangible property and results in receipts attributable to Minnesota); N.J. Stat. Ann. § 54:10A-2 (imposing tax on corporations for the privilege of deriving receipts from New Jersey sources); N.J. Admin. Code tit. 18, § 7-1.9(b) (providing – even before the statutory change referred to previously – that a foreign corporation that licenses trademarks to New Jersey corporations for use in New Jersey is subject to tax); Okla. Admin. Code § 710:50-17-3(a)(9) (licensing of intangible rights for use in Oklahoma creates nexus); Wis. Admin. Code § 2.82(4)9 (licensing of intangible rights for use in Wisconsin creates nexus).

of tax burdens from citizens to non-citizens at the expense of interstate commerce.

When one considers that the petitioners are non-resident intangible holding companies that have no physical presence in the State of North Carolina and that the State provides no benefits (fire or police protection or the like) to such companies, the resulting tax is a constitutional deterrent to interstate commerce. Indeed, in addition to "substantial nexus," one of the four prongs of *Complete Auto Transit, Inc. v. Brady*, 430 U.S. 274 (1977), requires that any taxes imposed must be fairly related to the services provided by the State. North Carolina does not provide services to any of the petitioners. Intangible property in a State does not travel the roads, and does not require police and fire protection. Disputes as to the marks, moreover, would not even involve state courts because intellectual property matters are routinely litigated in federal courts. This further buttresses the correctness of *Quill's* physical presence requirement in the context of the Commerce Clause. This Court's intervention is needed to ensure that States do not continue to tread on the Constitution in their attempts to shift their tax burdens to out-of-state entities.

B. The Adverse Consequences for Owners of Intangible Property

Entities around the country are faced time and again with States' attempts to collect taxes from non-residents based on the mere receipt of income from residents in such States. Without this Court's intervention, States will continue to try to get something for nothing by exporting their tax burden to out-of-state entities. The adverse

implications of North Carolina's theory are easily seen and illustrate the wisdom of this Court's adoption and confirmation of the physical presence standard. Utilization of the economic nexus theory applied by the North Carolina Court of Appeals below would result in virtually limitless state jurisdiction to impose income and franchise taxes on anyone and everyone who receives income that is in any measure related to a State. For example, authors, sports celebrities, teams, and actors who have never stepped foot into a State could be subject to income and franchise taxes by that State if they are paid royalties based upon the fact that a book that they have written was sold in the State, that property bearing their trademarked likeness or logo was sold in the State, or a movie in which they have acted was shown in theaters in that State. Likewise, under North Carolina's economic benefit theory, any holder of dividend-paying stock of a company that is physically present in the State could be subject to state income and franchise taxes.

The prospect of multiple taxation based on intangible property by various States is very real. The likelihood of litigation testing the contours of the presence of intangible property in any given jurisdiction is great and the continuing requests for this Court to review challenges to those determinations that are likely to ensue undermines the predictable worth of such business assets. Utilization of an economic nexus standard would be "an invitation to chaos." (App. H at 214a.) To avoid just such problems, in the international tax arena, the Organisation for Economic Co-operation and Development (OECD) Model Treaty and treaties with foreign nations require a "permanent establishment" as a prerequisite to the imposition of tax nexus

for non-resident corporations; merely deriving income is an insufficient basis for taxation.

Respondent's attempt to justify its imposition of state income and franchise taxes on petitioners based on the use of their intangible property by others is a violation of the nexus requirement of the Commerce Clause.

CONCLUSION

For the reasons set forth above, the petition for a writ of certiorari should be granted.

Respectfully submitted,

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Dated: June 2, 2005

APPENDIX A

NO. COA03-1203

NORTH CAROLINA COURT OF APPEALS

Filed: 7 December 2004

A&F TRADEMARK, INC.; CACIQUECO, INC.; EXPRESSCO, INC.; LANCO, INC.; LERNCO, INC.; LIMCO INVESTMENTS, INC.; LIMTOO, INC.; STRUCTURECO, INC.; and V. SECRET STORES, INC.,

Petitioners

v.

Wake County
No. 02 CVS 7467

E. NORRIS TOLSON, Secretary of Revenue, State of North Carolina, and his successors,

Respondents

Appeal by petitioners from order entered 22 May 2003 by Judge A. Leon Stanback in Wake County Superior Court. Heard in the Court of Appeals 8 June 2004.

Womble, Carlyle, Sandridge & Rice, by Burley B. Mitchell, Jr. and Sean E. Andrussier; Morrison & Foerster, L.L.P., by Paul H. Frankel and Hollis L. Hyans; and Alston & Bird, L.L.P., by Jasper L. Cummings, Jr., for petitioners-appellants.

Attorney General Roy Cooper, by Assistant Attorney General Kay Linn Miller Hobart, for respondent-appellee.

Nelson, Mullins, Riley & Scarborough, L.L.P., by George M. Teague, on behalf of North Carolina

Manufacturers Association, North Carolina Citizens for Business and Industry, North Carolina Biosciences Organization, and North Carolina Electronics and Information Technologies Association, amici curiae.

CALABRIA, Judge.

This appeal involves the assessment of corporate franchise and income taxes against A&F Trademark, Inc., Caciqueco, Inc., Expressco, Inc., Lanco, Inc., Lernco, Inc., Limco Investments, Inc., Limtoo, Inc., Structureco, Inc., and V. Secret Stores, Inc. (collectively, the "taxpayers"). Each of the taxpayers is a wholly-owned, non-domiciliary subsidiary corporation of the Limited, Inc. (the "Limited"), an Ohio corporation. Since 1963, the Limited has been engaged in retail sales and is currently engaged in the nationwide retail sale of men's, women's, and children's clothing and accessories via separate retail operating subsidiaries (the "related retail companies"), nine of which operate in North Carolina.[1] These related retail companies have over 130 locations in North Carolina.

Since the beginning of operations, the Limited developed and cultivated intangible intellectual property including trademarks, trade names, service marks, and associated goodwill. In so doing, the Limited incurred substantial expenses, which were deducted from gross income and reduced federal and North Carolina income taxes. In addition, all of the Limited's intellectual property was registered, monitored, policed, and defended against

[1] The nine retail companies are The Limited Stores, Inc., Cacique, Inc., Express, Inc., Lane Bryant, Inc., Lerner, Inc., Limited Too, Inc., Structure, Inc., Victoria's Secret, Inc., and Abercrombie & Fitch.

infringement by the Limited's own in-house legal counsel. During the 1980's and early 1990's, however, the Limited properly incorporated the taxpayers in Delaware as trademark holding companies and properly assigned to each of the taxpayers certain trademarks in separate I.R.C. § 351 tax-free exchanges. Each related retail company that assigned its trademark and associated goodwill to the related trademark holding company received little or no consideration for the transfer and did not have the trademark valued by a third party for a determination of its actual worth. The record on appeal indicates the trademarks at issue in this case had a value of approximately $1.2 billion dollars.

After the trademarks were assigned to the taxpayers, the related retail companies and the taxpayers entered into licensing agreements whereby the related retail companies licensed the marks back from the taxpayers.[2] The net result of the assignment and licensing back was that there was no change in the day-to-day operations of the related retail companies. However, each licensing agreement required the related retail company to pay to the proper taxpayer, as licensor, a royalty payment for the use of the trademark in the amount of five to six percent of its retail operating gross sales. These payments were made by an accounting journal entry. No checks were written and no physical transfer of funds occurred. Subsequently, the taxpayers entered into agreements loaning

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[2] Limco Investments, Inc. ("Limco") licensed trademark rights to The Limited, Inc.; Caciqueco, Inc. to Cacique, Inc.; Expressco, Inc. to Express, Inc.; Lanco., Inc. to Lane Bryant, Inc.; Lernco, Inc. to Lerner, Inc.; Limtoo, Inc. to Limited Too, Inc.; Structureco, Inc. to Structure, Inc.; V. Secret Stores, Inc. to Victoria's Secret, Inc.; and A&F Trademark, Inc. to Abercrombie and Fitch, Inc.

any excess operating funds back to the related retail companies in the form of notes receivable bearing a market rate of interest.[3] No attempts were made to collect any outstanding notes, and they were marked "Do Not Collect." Under the licensing and loan agreements, the related retail companies collectively paid to the taxpayers $301,067,619 in royalties and $122,031,344 in interest in 1994, accounting for 100% of the taxpayers' income for that year. The related retail companies deducted these royalty and interest expenses for tax purposes. The taxpayers have no employees and share office space, equipment, and supplies; their listed primary office address is also the primary office address of approximately 670 other companies unrelated to the Limited or its wholly-owned subsidiaries.

The taxpayers did not file corporate franchise and income tax returns in North Carolina for their fiscal years ending 31 January 1994. North Carolina's Secretary of Revenue (the "Secretary" or "respondent") gave notice of proposed assessments of corporate franchise and income tax. The taxpayers protested and, after an administrative hearing, the Secretary issued a final decision on 19 September 2000 sustaining the proposed assessments against the taxpayers without penalties. The taxpayers appealed to the Tax Review Board, which affirmed the final decision. The taxpayers filed a petition in Wake County Superior Court, requesting that the decision be reversed or, in the alternative, modified. By order filed 22 May

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[3] By way of example, the Tax Review Board found that, for the tax years 1992 through 1994, "Limco's total expenses . . . were $729,175, [or] 0.2% of its total accrued income of $311,952,574 during the same period."

2003, the trial court summarily determined that the "Administrative Decision of the Tax Review Board should be affirmed in its entirety." From that order, the taxpayers appeal to this Court.

On appeal, two primary issues are presented. First, we must determine whether the taxpayers were "doing business" in North Carolina under the relevant statutory provisions, and second, we must determine whether respondent's attempt to assess the taxes in the instant case offends the Commerce Clause of the United States Constitution. If we conclude the taxpayers were doing business and the tax imposed was constitutionally sound, we must further determine whether the taxpayers are "excluded corporations" under N.C. Gen. Stat. § 105-130.4(a)(4) (2003). Each issue involves either a question of statutory construction or the taxpayers' constitutional rights. Accordingly, our standard of review is *de novo*. *Piedmont Triad Airport Auth. v. Urbine*, 354 N.C. 336, 338, 554 S.E.2d 331, 332 (2001); *In re Proposed Assessments v. Jefferson-Pilot Life Ins. Co.*, 161 N.C. App. 558, 559, 589 S.E.2d 179, 180 (2003).

I. Doing Business

The taxpayers first assert the Department of Revenue ("DOR") lacked statutory authority to tax them because they were not "doing business" in North Carolina. Specifically, the taxpayers assert "they did not transact business in this State and [neither sought nor] were required to seek . . . authorization to conduct business in this State." In addition, the taxpayers point out they had no offices, employees, tangible property, transactions with residents, or customer service in North Carolina.

A. Income Tax

Under N.C. Gen. Stat. § 105-130.3 (2003), "[a] tax is imposed on the State net income of every C Corporation doing business in this State." In administering the duties under N.C. Gen. Stat. § 105-130.3, the Secretary adopted N.C. Admin. Code tit. 17, r. 5C.0102(a) (2004), defining "doing business in this State" as that phrase was used in the statute for income tax purposes. N.C. Admin. Code tit. 17, r. 5C.0102(a) provides, in pertinent part, as follows:

> For income tax purposes, the term "doing business" means the operation of any business enterprise or activity in North Carolina for economic gain, including . . . the owning, renting, or operating of business or income-producing property in North Carolina including . . . [t]rademarks [and] tradenames . . . .

According to our Supreme Court, "'[t]he construction adopted by the administrators who execute and administer a law in question is one consideration where an issue of statutory construction arises.'" *Polaroid Corp. v. Offerman*, 349 N.C. 290, 301, 507 S.E.2d 284, 293 (1998) (quoting *John R. Sexton & Co. v. Justus*, 342 N.C. 374, 380, 464 S.E.2d 268, 271 (1995)). "[S]uch construction is 'strongly persuasive' and . . . entitled to 'due consideration.'" *See id.*, 349 N.C. at 302, 507 S.E.2d at 293 (quoting *Shealy v. Associated Transp., Inc.*, 252 N.C. 738, 742, 114 S.E.2d 702, 705 (1960)). Indeed, under operation of N.C. Gen. Stat. § 105-264 (2003), the Secretary's interpretation of a statute he administers is "prima facie correct."

The taxpayers assert N.C. Admin. Code tit. 17, r. 5C.0102(a) "is of no consequence" because amendments to the income tax statute occurring in 2001 (the "2001 amendments") indicates "that the agency's rule [improperly]

expanded the income tax statute" instead of interpreting it. *See Duke Power Co. v. Clayton, Comr. of Revenue*, 274 N.C. 505, 511, 164 S.E.2d 289, 294 (1968) (holding an administrative interpretation "cannot change the meaning of a statute or control the Court's interpretation of it"). The taxpayers argue the only possible purpose for the 2001 amendments was to "cover the receipt of royalty income from the in-state use of licensed trademarks[;]" therefore, the administrative rule must be deemed an improper expansion of the statute prior to 2001.

During the 2001 session, the General Assembly amended "Part 1 of Article 4 of Chapter 105 of the General Statutes . . . by adding a new section." 2001 N.C. Sess. Laws 327, s. 1.(b). The bill amending the statute was entitled "An Act to Combat Tax Fraud, Enhance Corporate Compliance with Taxes on Trademark Income, [and] Assure that Franchise Tax Applies Equally to Corporate Assets[.]" 2001 N.C. Sess. Laws 327. The 2001 amendments added a royalty income reporting option with the stated purpose of "provid[ing] taxpayers with an option concerning the method by which . . . royalties [received for the use of trademarks in North Carolina as income derived from doing business in this State] can be reported for taxation when the recipient and the payer are related members."[4] *Id.*, s. 1.(a). The General Assembly expressed its intent in enacting the royalty reporting option as follows: "It is the intent of this section [N.C. Gen. Stat.

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[4] Royalty is defined as "[a]n amount charged that is for, related to, or in connection with the use in this State of a trademark. The term includes royalty and technical fees, licensing fees, and other similar charges." 2001 N.C. Sess. Laws 327, s. 1.(b). Our use of the term royalty or royalty income will apply to both the taxpayers' royalty and interest income.

§ 105-130.7A] to reward taxpayers who comply [with the State tax on income generated from using trademarks in manufacturing and retailing activities]." 2001 N.C. Sess. Laws 327, s. 1.(a). Examining the title, purpose, and intent of the 2001 amendments, it is clear that the taxpayers' contention cannot be sustained.

First, the title of the bill clearly denotes that its function was to enhance compliance "with the State tax on income generated from using trademarks in [manufacturing and retailing] activities." *Id.* Though elementary in nature, we note such a function necessarily contemplates not only that current corporate practices were insufficiently compliant but also that there existed such enacted taxes on trademark income with which corporations were actually required to comply. Second, in a related manner, the title of the amendment designates that its function, in part, was to combat tax fraud. It is difficult to determine how tax fraud could occur in the absence of laws or regulations requiring the payment of taxes. *See Black's Law Dictionary* 1474 (7th ed. 1999) (defining tax fraud and tax evasion as "[t]he willful attempt to defeat or circumvent the tax law in order to illegally reduce one's tax liability"). Third, the stated purpose was merely to add a reporting option to the income tax statute, not to modify or change what constituted taxable income.[5] Fourth, the intent of the legislature is made clear on the face of the session law: to reward corporations complying with state income tax provisions imposing taxes on the use of trademarks in certain activities, including retailing. In summary, the

[5] That the amendment was designed to permit corporations to change the method of reporting fully explains why it is to be applied prospectively. *See* 2001 N.C. Sess. Laws 327, s. 1.(f).

language contained in the 2001 amendments supports the premise that N.C. Admin. Code tit. 17, r. 5C.0102(a) was consistent with N.C. Gen. Stat. § 105-130.3 rather than an expansion of it.

Our determination that the 2001 amendments endorsed rather than changed the scope of the income tax statute has fatal effects on the remaining arguments asserted by the taxpayers. The taxpayers' remaining arguments depend on the premise that the phrase "doing business in this State" in N.C. Gen. Stat. § 105-130.3 does not encompass their activities in North Carolina; therefore, DOR exceeded its statutory authority in imposing the income taxes at issue in the instant case. However, the taxpayers have proffered no other argument against the Secretary's interpretation and have thus failed to rebut the presumption that it is *prima facie* correct. This is especially true in light of our discussion concerning the 2001 amendments, which indicates that the administrative rule, at all times, has properly reflected the policy of the General Assembly for income taxation of trademark royalty payments.

"[T]he legislature is always presumed to act with full knowledge of prior and existing law . . . ." *Polaroid Corp.*, 349 N.C. at 303, 507 S.E.2d at 294. Thus, when a statute is interpreted, and the legislature acquiesces in that interpretation by failing to amend the statutory provision, our courts assume the legislature "is satisfied with that interpretation" and accord it "'great weight in arriving at [the statute's] meaning.'" *Id.* (quoting *State v. Emery*, 224 N.C. 581, 587, 31 S.E.2d 858, 862 (1944)). The administrative rule as modified in 1992 is directly applicable for income tax purposes to the taxpayers' activities in North Carolina. In the following two years, the General Assembly

did nothing to indicate its dissatisfaction with N.C. Admin. Code tit. 17, r. 5C.0102(a), and nine years later, it amended Article 4 of Chapter 105 of the General Statutes to add a royalty income reporting option *to reward and enhance compliance* with N.C. Admin. Code tit. 17, r. 5C.0102(a), the administrative rule the taxpayers assert is of "no consequence." Far from passively acquiescing in the Secretary's interpretation, the General Assembly endorsed it. Accordingly, we find unpersuasive any argument that the administrative rule exceeded the reach of the statutory income tax provisions as contemplated by the General Assembly.

B. Franchise Tax

The taxpayers also assert the imposition of franchise taxes by DOR exceeded its statutory authority. North Carolina General Statutes § 105-122 (2003) imposes a franchise tax on "[e]very corporation . . . doing business in" North Carolina. For franchise tax purposes, "doing business" is defined as "[e]ach and every act, power, or privilege exercised or enjoyed in this State, as an incident to, or by virtue of the powers and privileges granted by the laws of this State." N.C. Gen. Stat. § 105-114(b)(3) (2003).[6] Our Supreme Court has characterized this tax as one "imposed upon corporations for the opportunity and privilege of transacting business in this State. It is an annual tax which varies with the nature, extent and magnitude of the business conducted by the corporation in this State." *Realty Corp. v. Coble, Sec. of Revenue*, 291 N.C. 608, 611,

[6] We agree with the taxpayers that N.C. Admin. Code tit. 17, r. 5C.0102(a), which by its own terms is "[f]or income tax purposes," has no application to DOR's authority to impose a franchise tax in this case.

231 S.E.2d 656, 658 (1977). The taxpayers assert the franchise tax is a *quid pro quo* where the business compensates the State for the burden of protecting and fostering the endeavor, and such a *quid pro quo* is "utterly lacking here." We disagree.

It is beyond dispute that North Carolina has provided privileges and benefits that fostered and promoted the related retail companies. By affording these benefits to the related retail companies, additional benefits have inured to the taxpayers. If, as the taxpayers assert, the heart of the franchise tax statute is the legitimate expectation of the State to ask for something in return for that which it has provided, we fail to see how North Carolina has not promoted or fostered the taxpayers' endeavors. In addition, we agree with the broad rationale accepted by the Supreme Court of South Carolina that by providing an orderly society in which the related retail companies conduct business, North Carolina has made it possible for the taxpayers to earn income pursuant to the licensing agreements. *See Geoffrey, Inc. v. South Carolina Tax Commission*, 437 S.E.2d 13, 18 (S.C. 1993) (upholding a tax imposed on that portion of a non-domiciliary trademark holding company's income derived from the use of its trademarks and trade names within South Carolina by a related retail company). The protection of North Carolina's marketplace by the State provides the *quid pro quo* for which the State can expect a return. We hold the taxpayers were "doing business in this State;" therefore, the State did not exceed its authority by imposing franchise taxes.

II. Commerce Clause

The taxpayers alternatively assert that, even if they were doing business within the contemplation of the applicable statutory provisions, the Commerce Clause of the United States Constitution forbids North Carolina from imposing the taxes at issue in this case. The taxpayers contend they have no "substantial nexus" with North Carolina on the grounds that they have no physical presence within the State.

The United States Constitution vests the United States Congress with the power "[t]o regulate commerce with foreign nations, and among the several states[.]" U.S. Const. art I, § 8, cl.3. "[T]he Commerce Clause is more than an affirmative grant of power; it has a negative sweep as well. . . . '[B]y its own force' [it] prohibits certain state actions that interfere with interstate commerce." *Quill Corp. v. North Dakota*, 504 U.S. 298, 309, 119 L. Ed. 2d 91, 104 (1992) (quoting *South Carolina State Highway Dept. v. Barnwell Brothers, Inc.*, 303 U.S. 177, 185, 82 L. Ed. 734, 739 (1938)). This "negative sweep" is commonly referred to as the dormant Commerce Clause, which has been interpreted to limit a state's power to tax. *Id.*

Under current United State Supreme Court jurisprudence, a tax challenged on Commerce Clause grounds will be upheld where it "[1] is applied to an activity with a substantial nexus with the taxing State, [2] is fairly apportioned, [3] does not discriminate against interstate commerce, and [4] is fairly related to the services provided by the State." *Complete Auto Transit, Inc. v. Brady*, 430 U.S. 274, 279, 51 L. Ed. 2d 326, 331 (1977). "The second and third parts of [the *Complete Auto*] analysis . . . prohibit taxes that pass an unfair share of the tax burden

onto interstate commerce. The first and fourth prongs . . . limit the reach of the state taxing authority so as to ensure that state taxation does not unduly burden interstate commerce." *Quill*, 504 U.S. at 313, 119 L. Ed. 2d at 107. Nonetheless, the Supreme Court has repeatedly reiterated that "[i]t was not the purpose of the commerce clause to relieve those engaged in interstate commerce from their just share of [the] state tax burden even though it increases the cost of doing the business." *Western Live Stock v. Bureau of Revenue*, 303 U.S. 250, 254, 82 L. Ed. 823, 827 (1938).

The taxpayers' assertion on appeal, that they did not have a substantial nexus with North Carolina because they have no physical presence in this State, is premised upon the first prong of the *Complete Auto* test. The taxpayers contend that the presence of their intangible property in North Carolina is irrelevant in light of the lack of physical presence of offices, facilities, employees, and real or tangible property, and that the Supreme Court's rulings in *National Bellas Hess, Inc. v. Department of Revenue*, 386 U.S. 753, 18 L. Ed. 2d 505 (1967) and *Quill* mandate that this Court find the tax sought to be imposed by the State violates the Commerce Clause. We disagree.

Both *Bellas Hess* and *Quill* involved attempts by a state to require out-of-state mail-order vendors to collect and pay use taxes on goods purchased within the state despite the fact that the vendors had no outlets or sales representatives in the state. The Supreme Court's decision in *Bellas Hess* "stands for the proposition that a vendor whose only contacts with the taxing State are by mail or common carrier lacks the 'substantial nexus' required by the Commerce Clause." *Quill*, 504 U.S. at 311, 119 L. Ed. 2d at 106. In 1992, *Quill* re-affirmed and clarified the

holding in *Bellas Hess* and unequivocally divorced the respective nexus requirements of the Due Process Clause and the Commerce Clause. *Id.*, 504 U.S. at 312, 119 L. Ed. 2d at 106. In doing so, the Supreme Court cited the divergent aims of the two clauses: due process "centrally concerns the fundamental fairness of government activity" as against an "individual defendant" as opposed to the Commerce Clause's focus on the "structural concerns about the effects of state regulation on the national economy." *Id.* Crucial to the taxpayers' argument on appeal, the Supreme Court in *Quill* ultimately concluded that, for purposes of sales and use taxes assessed against vendors whose only contact with a state is by mail or common carrier, the substantial nexus prong of *Complete Auto* could appropriately be determined by application of a "bright-line, physical-presence requirement." *Id.*, 504 U.S. at 317, 119 L. Ed. 2d at 110. The taxpayers suggest this requirement applies to *all taxes* employed by the states for Commerce Clause nexus analyses and, specifically, must be used in determining whether the taxes in the present case are constitutionally infirm. We decline to adopt the broad reading of *Quill* suggested by the taxpayers for numerous reasons.

First, the tone in the *Quill* opinion hardly indicates a sweeping endorsement of the bright-line test it preserved, and the Supreme Court's hesitancy to embrace the test certainly counsels against expansion of it. In its discussion of the Commerce Clause, the Supreme Court briefly summarized the numerous and shifting analyses endorsed since recognition of the dormant Commerce Clause. The Court went on to note that, while *Bellas Hess* did not conflict with recent Commerce Clause cases, "contemporary Commerce Clause jurisprudence might not dictate

the same result were the issue to arise for the first time today." *Quill*, 504 U.S. at 311, 119 L. Ed. 2d at 105. The Court stated that the evolution of its "recent Commerce Clause decisions . . . signaled a 'retreat from the formalistic constrictions of a stringent physical presence test in favor of a more flexible substantive approach[.]'" *Quill*, 504 U.S. at 314, 119 L. Ed. 2d at 107. The Court further observed the physical-presence test, though offset by the clarity of the rule, was "artificial at its edges." *Quill*, 504 U.S. at 315, 119 L. Ed. 2d at 108. In addition, the Court twice noted that in other types of taxes, it had never articulated the same physical-presence requirement adopted in *Bellas Hess, see Quill*, 504 U.S. at 314 and 317, 119 L. Ed. 2d at 108 and 110, but cautioned that the failure to expand the *Bellas Hess* rule established for sales and use taxes to other types of taxes did not imply that the *Bellas Hess* rule as applied to sales and use taxes was vestigial or disapproved. *Id.* Nonetheless, the Court's choice to abstain from rejecting the *Bellas Hess* rule for sales and use taxes fails to argue persuasively that the rule should, for lack of rejection, be augmented to cover other types of tax. While the Supreme Court may ultimately choose to expand the scope of the physical-presence test reaffirmed in *Quill* beyond sales and use taxes, its equivocal reaffirmation of that test does not readily make that choice self-evident.

Second, retention of the *Bellas Hess* test was grounded, in no small part, on the principle of *stare decisis* and the "substantial reliance" on the physical-presence test, which had "become part of the basic framework of a sizable industry." *Quill*, 504 U.S. at 317, 119 L. Ed. 2d at 110. Neither consideration advocates for the position adopted by the taxpayers in the present case. We need look

no further than the language in *Quill* to summarily dispense with the possibility that *stare decisis* plays an analogous role in the instant case: the Supreme Court, as noted before, twice expressed that the bright-line, physical-presence requirement of *Bellas Hess* had not been adopted in other forms of taxation. Moreover, since the physical-presence requirement has never been established by judicial precedent for other forms of taxation and since this form of tax reduction in the instant case is relatively new, we dismiss the possibility that analogous substantial reliance, as contemplated in *Quill*, exists in this case.

Third, there are important distinctions between sales and use taxes and income and franchise taxes "that makes the physical presence test of the vendor use tax collection cases inappropriate as a nexus test[.]" Jerome R. Hellerstein, Geoffrey *and the Physical Presence Nexus Requirement of* Quill, 8 State Tax Notes 671, 676 (1995). "[T]he use tax collection cases were based on the vendor's activities in the state, whereas" the income and franchise taxes in the instant case are based solely on "the use of [the taxpayer's] property in th[is] state by the licensee[s]" and not on any activity by the taxpayers in this State. *Id.* The "Supreme Court has made it clear that the presence of the recipient of income from intangible property in a state is not essential to the state's income tax on income of a nonresident." *Id.* (citing *International Harvester Co. v. Wisconsin Dept. of Taxation*, 322 U.S. 435, 441-42, 88 L. Ed. 1373, 1380 (1944) for the proposition that states are entitled to tax a non-resident's income to the extent it is "fairly attributable either to property located in the state or to events or transactions which, occurring there, are subject to state regulation and which are within the protection of the state and entitled to the numerous other

benefits which it confers").[7] Since the tax at issue in this case is not based on the taxpayers' activity in North Carolina, but rather on the taxpayers' receipt of income from the use of the taxpayers' property in this State by a commonly-owned third party, "it would [be] inappropriate and, indeed, anomalous . . . [to determine] nexus by [the taxpayers'] activities or [their] physical presence" in North Carolina. *Id.* Moreover, "[u]nlike an income tax, a sales and use tax can make the taxpayer an agent of the state, obligated to collect the tax from the consumer at the point of sale and then pay it over to the taxing entity." *Kmart Properties, Inc. v. Taxation and Revenue Dep't. of New Mexico*, No. 21,140, at 13 (N.M. Ct. App. Nov. 27, 2001) ("*Kmart*").[8] "[A] state income tax is usually paid only once a year, to one taxing jurisdiction and at one rate, [but] a sales and use tax can be due periodically to more than one taxing jurisdiction within a state and at varying rates." *Id.*, at 13.

Given these reasons, we reject the contention that physical presence is the *sine qua non* of a state's jurisdiction to tax under the Commerce Clause for purposes of income and franchise taxes. Rather, we hold that under

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[7] Opponents of *Geoffrey's* rationale vigorously resist the use of *International Harvester* on the grounds that it concerned a Due Process challenge. We acknowledge the validity of the point; however, the central holding of *International Harvester* has been overwhelmingly endorsed: a State in which a corporation conducts business and earns income may impose a tax on that portion earned therein.

[8] *Kmart* was an unpublished opinion. Accordingly, while citation is disfavored and it has no binding precedential authority, we nonetheless consider and find persuasive those portions of the opinion reproduced herein. References to *Kmart* will provide page numbers as appearing on the copy of the opinion filed with the Clerk of the New Mexico Court of Appeals.

facts such as these where a wholly-owned subsidiary licenses trademarks to a related retail company operating stores located within North Carolina, there exists a substantial nexus with the State sufficient to satisfy the Commerce Clause. *Accord Geoffrey*, 437 S.E.2d at 18 (holding that "by licensing intangibles [to Toys 'R Us, an affiliated operating store,] for use in [South Carolina] and deriving income from their use [t]here, Geoffrey ha[d] a 'substantial nexus' with South Carolina"); *Kmart*, at 15 (holding that "the use of KPI's [the wholly-owned trademark holding company licensor] marks within New Mexico's economic market, for the purpose of generating substantial income for KPI, establishe[d] a sufficient nexus between that income and the legitimate interests of the state and justifie[d] the imposition of a state income tax").

We are also cognizant of the holding of the New Jersey Tax Court in a case involving one of the taxpayers before this Court on the same issue. *Lanco, Inc. v. Dir., Div. of Tax'n.*, 21 N.J. Tax 200 (2003). In that case, the New Jersey Tax Court concluded "that the physical presence of the taxpayer or its employee(s), agent(s), or tangible property in a jurisdiction has been and remains a necessary element for a finding of substantial nexus under the Commerce Clause of the United States Constitution." *Id.*, 21 N.J. Tax at 214. We respectfully disagree. Summarizing the salient portions of that opinion, the New Jersey Tax Court (1) found it "illogical" to have a physical presence as a constitutional necessity for sales and use taxes but not for income tax, (2) opined physical presence, as a prerequisite to state taxation of income, was "fully consistent with and strongly suggested by the Commerce Clause cases decided before *Quill*" because the circumstances of those

cases involved taxpayers who were physically present in the state attempting to impose the tax, and (3) stated "other state court cases decided since *Quill* do not follow the *Geoffrey* rule." *Id.*, 21 N.J. Tax at 208-09.[9]

Regarding the first reason given by the New Jersey Tax Court, the *Quill* opinion itself twice notes the singularity of its adoption and reaffirmation of the physical-presence test for Commerce Clause nexus in the arena of sales and use taxes. Moreover, as illustrated by our analysis herein, we disagree with the New Jersey Tax Court that there do not exist certain distinctions between the tax at issue in *Quill* and those considered in the instant case that justify divergent treatment. Regarding the second reason, we do not accord the same import to pre-*Quill* cases in which it was far more likely that a taxpayer would be required to be physically present (in the traditional commercial sense) in a state in order to earn income there. Lastly, the third reason espoused by the New Jersey Tax Court rings hollow. For example, in discussing *General Motors Corp. v. City of Seattle*, 25 P.3d 1022 (Wn. App. 2001), *cert. den.*, 535 U.S. 1056, 152 L. Ed. 2d 825 (2002),

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[9] The taxpayers also argue, as persuasive authority, the holding of the Court of Appeals of Tennessee in *J.C. Penney National Bank v. Johnson*, 19 S.W.3d 831 (Tenn. Ct. App. 1999). We are not persuaded. While the reasoning of *J.C. Penney* appears, at first blush, to extend *Quill's* physical presence test to income taxes, the Tennessee Court expressly abstained from determining "whether 'physical presence' is required under the Commerce Clause[,]" *see id.*, 19 S.W.3d at 842, and a subsequent unpublished opinion from that same Court casts considerable doubt on whether it adopted "a bright-line test of requiring an out-of-state company to have a 'physical presence' in [Tennessee] in order to have a substantial nexus with it." *America Online, Inc. v. Johnson*, No. M2001-00927-COA-R3-CV, Tenn. Ct. App., July 30, 2002, at 2.

the New Jersey Tax Court dismisses the Washington appellate court's express declaration that it "decline[d] to extend *Quill's* physical presence requirement" to a business and occupation tax on the basis that the taxpayers in that case had a physical presence in that jurisdiction. The corporation's physical presence can hardly serve to obscure the Washington Court's unequivocal choice to stand with *Geoffrey's* containment of the *Quill* physical-presence test. More importantly, any assertion that *Geoffrey* has not been, by and large, approved of in subsequent cases cannot be sustained. *See* J. Hellerstein & W. Hellerstein, State Taxation, Para. 6.11[3] at 6-16 (Warren, Gorham & Lamont, 3d ed. Cum. Supp. 2004) (comprehensively analyzing judicial and administrative post-*Geoffrey* developments and summarizing that, although mixed, "judicial and administrative reaction to the opinion across the country has generally supported [*Geoffrey's*] position that *Quill's* physical-presence test of Commerce Clause nexus does not extend to income taxes").

III. Apportionment

In their last assignment of error, the taxpayers assert the decisions below improperly concluded they were excluded corporations and improperly applied an unfavorable apportionment formula. In 1994, an "excluded corporation" was statutorily defined, in part, as "a corporation which receives more than fifty percent (50%) of its ordinary gross income from investments in and/or dealing in intangible property." N.C. Gen. Stat. § 105-130.4 (Cum. Supp. 1994). The taxpayers assert they "do not fit within that definition because they were not deriving their income from 'investments and/or dealing in' trademarks." Rather, taxpayers contend they earned revenue by "licensing,

owning, managing and protecting trademarks," which lies outside of the plain meaning of "deal in" as set forth in *Chrysler Fin. Co. v. Offerman*, 138 N.C. App. 268, 273, 531 S.E.2d 223, 226 (2000) (defining "deal in" as "to engage in buying and selling some commodity" pursuant to *New Webster's Dictionary and Thesaurus of the English Language* 247 (1992)). While the definition used in *Chrysler* certainly constitutes one facet of the plain meaning of "deal" or "deal in," the recognition of that facet of the term's plain meaning does not and cannot obviate other commonly accepted definitions that provide the plain meaning of the term as used in the statute. For example, "deal" is defined as "to do business" by *The American Heritage College Dictionary* 356 (3rd ed. 1997). We do no violence to the plain meaning of "deal in" by holding that it encompasses the taxpayers' activities with respect to the trademarks. This assignment of error is overruled.

We have carefully considered the taxpayers' remaining arguments and find them to be without merit.

Affirmed.

Judges WYNN and LEVINSON concur.

APPENDIX B

NORTH CAROLINA **WAKE COUNTY**	**IN THE GENERAL COURT OF JUSTICE SUPERIOR COURT DIVISION 02-CV-007467**
A&F TRADEMARK, INC.; CACIQUECO, INC.; EXPRESSCO, INC.; LANCO, INC.; LERNCO, INC.; LIMCO INVESTMENTS, INC.; LIMTOO, INC.; STRUCTURECO, INC.; V. SECRET STORES, INC., **Petitioners,** **v.** **E. NORRIS TOLSON, SECRETARY OF REVENUE, STATE OF NORTH CAROLINA AND HIS SUCCESSORS,** **Respondents.**	**ORDER** **(Filed May 22, 2003)**

THIS MATTER coming on to be heard and being heard before the undersigned Judge Presiding at the 7 April 2003 civil session of Wake County superior court, upon a petition for judicial review pursuant to G.S. §§ 105-241.3 and 150B-45 by A&F Trademark, Inc.; Caciqueco, Inc.; Expressco, Inc.; Lanco, Inc.; Lernco, Inc.; Limco Investments, Inc.; Limtoo, Inc,; Structureco, Inc.; and V. Secret Stores, Inc. ("Petitioners"), appealing Administrative Decision No. 381 of the Tax Review Board entered 7 May, 2002, affirming Final Decision Docket No. 97-990 of the Secretary of Revenue; and

THE COURT having reviewed the pleadings, the record, exhibits, other matters of record, and having

considered the briefs filed by the parties and having heard the arguments of counsel; and having further reviewed and examined the Administrative Decision of the Tax Review Board heretofore entered and the record upon which such decision rests; and the matter having been heard and reviewed in compliance with the requirements of Article 4 of Chapter 150B of the General Statutes, the Court finds that:

The Administrative Decision of the Tax Review Board is: (1) not in violation of constitutional provisions; (2) not in excess of the statutory authority or jurisdiction of the agency; (3) made upon lawful procedure; (4) not affected by error of law; (5) supported by substantial evidence in view of the entire record as submitted; and (6) not arbitrary, capricious or an abuse of discretion; and the Court further finds that:

The substantial rights of the Petitioners have not been prejudiced by the decision of the Tax Review Board; and the Court further finds that:

The Administrative Decision of the Tax Review Board should be affirmed in its entirety.

NOW, THEREFORE, IT IS ORDERED, ADJUDGED AND DECREED that Administrative Decision No. 381 of the Tax Review Board is AFFIRMED in its entirety. Petitioners shall pay costs.

This the 22d day of May 2003.

/s/ A. Leon Stanback
A. Leon Stanback
Judge Presiding

APPENDIX C

STATE OF NORTH CAROLINA
COUNTY OF WAKE

BEFORE THE TAX REVIEW BOARD

IN THE MATTER OF:
The Proposed Corporate Franchise and Income Tax Assessments for the Fiscal Years of January 31, 1992 through January 31, 1994 by the Secretary of Revenue of North Carolina

vs.

A&F Trademark, Inc.,
Caciqueco, Inc.,
Expressco, Inc.,
Lanco, Inc.,
Lernco, Inc.,
Limco Investments, Inc.,
Limtoo, Inc.,
Structureco, Inc.
V. Secret Stores, Inc.

ADMINISTRATIVE DECISION
Number: 381

This matter was heard before the Tax Review Board (hereinafter "Board") in the City of Raleigh, Wake County, North Carolina, in the office of the State Treasurer on Thursday, February 14, 2002, upon the Petition of A&F Trademark, Inc., Caciqueco, Inc., Expressco, Inc., Lanco, Inc., Lernco, Inc., Limco Investments, Inc., Limtoo, Inc., Structureco, Inc., and V. Secret Stores, Inc. ("hereinafter Taxpayers") for administrative review of the Final Decision of Michael A. Hannah, Assistant Secretary of the North Carolina Department of Revenue, entered on September 19, 2000, sustaining the Department's proposed assessment of

corporate franchise and income taxes for fiscal year ended January 31, 1994.

Chairman Richard H. Moore, State Treasurer, presided over the hearing with Jo Anne Sanford, Chair. Utilities Commission and duly appointed member. Noel L. Allen, Attorney at Law participating.

Paul H. Frankel, Hollis L. Hyans, and Craig B. Fields of Morrison & Foerster, LLP, and Jasper L. Cummings, Jr., of Alston & Bird, LLP represented the Taxpayers at the hearing. Kay Miller Hobart, Assistant Attorney General, represented the Secretary of Revenue at the hearing.

STATEMENT OF FACTS

The Taxpayers are nine wholly-owned subsidiaries of the Limited Stores, Inc. (the "Limited") an Ohio corporation. The Limited also owns 100% of eight retail companies. Those companies are: Lane Bryant, Inc.; Lerner, Inc.; Victoria's Secret, Inc., Cacique, Inc.; Abercrombie & Fitch, Inc.; Limited Too, Inc.; Express, Inc.; and Structure, Inc.

The Limited and the wholly-owned eight retail subsidiaries are doing business in North Carolina and pay corporate income and franchise taxes here. During the year at issue, the Limited and the eight retail subsidiaries operated over 130 retail locations in North Carolina.

Taxpayers were incorporated in Delaware to hold the trademarks owned by the Limited and the related retail companies. The marks owned by the Taxpayers include "The Limited," "Limited Too," "Victoria's Secrets," "Express," "Structure," "Cacique," "Abercrombie and Fitch," "Lane Bryant," and "Lerner." The marks are a form of intangible personal property. The Taxpayers do not own or

lease any real property or tangible personal property in any state except Delaware. The Taxpayers have no employees in any state. The Taxpayers received the marks they own in separate I.R.C. Section 351 tax-free exchanges with the related retail companies. In these exchanges, the related retail companies transferred the marks to the Taxpayers for little or no consideration. The Taxpayers then entered into a licensing agreement with the corresponding related retail companies. The licensing agreements authorized the related retail companies to continue to use the marks they had previously owned in exchange for royalty payments to the Taxpayers. These agreements required the retail stores to pay Taxpayers a royalty fee based on the percentage of the retail companies' gross sales. The Limited and the related retail companies deducted these royalty payments from their income for North Carolina tax purposes. Taxpayers then loaned these royalty payments back to the related companies for use in their retail operations. Taxpayers charged the retail companies a market rate of interest, which generated further deductions for the related retail companies.

Taxpayers did not pay any income tax to any state on any of the income received from the related retail companies. For the year at issue (1994), Taxpayers recorded $301,067,619 in royalty income and $122,031,344 in interest income from the related retail companies. This accounted for 100% of Taxpayers' income.

STATEMENT OF CASE

The Department of Revenue issued proposed notices of tax assessments, which the Taxpayers protested. On June 9, 10, and June 11, 1998, a three-day administrative

hearing was held before Michael A. Hannah, the Assistant Secretary of Revenue. On September 19, 2000, the Assistant Secretary issued the Final Decision. In the Final Decision, the Assistant Secretary cancelled the assessments for the Taxpayers' fiscal years ended January 31, 1992 and January 31, 1993, which were fiscal years that began prior to the November 2, 1992 effective date of the Administrative Rule. The Assistant Secretary also waived all penalties asserted by the Department of Revenue against the Taxpayers. However, the Assistant Secretary sustained the Department of Revenue's assessment of corporate franchise and income tax against the Taxpayers for the fiscal year ended January 31, 1994. In this Final Decision, the Assistant Secretary concluded that the Taxpayers were doing business in North Carolina. He also concluded that the contractual relationship between the Taxpayers and their Licensees created an agency relationship and that all of the activities that the Licensees were required to perform under the license agreements were attributable to Taxpayers. Additionally, the Assistant Secretary concluded that Taxpayers were "excluded corporations" under G.S. 105-130.4(a)(4), and are therefore required to use a single sales factor as their apportionment formula under G.S. 105-130.4(r) & (1). The Assistant Secretary also determined that the Taxpayers could be required to be included in combined reports with their related Licensees. On December 15, 2000, Taxpayers filed with the Board a Petition for Administrative Review of the Final Decision pursuant to G.S. 105-241.2.

ISSUES

The issues considered by the Board upon administrative review of this matter are stated as follows:

1. Whether the Taxpayers were "doing business" in this State within the meaning of G.S. 105-130.3 and G.S. 105-114 so as to be subject to the corporate income and franchise tax.

2. Whether the Taxpayers were "excluded corporations" within the meaning of G.S. 105-130.4(a)(4).

EVIDENCE

The evidence presented at the hearing before the Assistant Secretary of Revenue and included in the record for the Board's review is attached as Exhibit A and is incorporated by reference herein.

FINDINGS OF FACT

The Board reviewed the following findings of facts made by the Assistant Secretary in his final decision:

1. The Taxpayers are nine non-domiciliary corporations headquartered in Delaware.

2. The Taxpayers are wholly-owned subsidiaries of the Limited, Inc. ("Limited").

3. The Limited is primarily engaged in the nationwide retail sale of men's, women's, and children's clothing and accessories.

4. The Limited's principal place of business and commercial domicile is located in Columbus, Ohio.

5. The Limited started in business in 1963 and has expanded to over 5,000 stores nationwide and 12 separate retail operating subsidiaries.

6. The Limited and its retail operating subsidiaries ("related retail companies") own and operate all of their stores; none are franchised.

7. The Taxpayers own and license trademarks, tradenames, and service marks ("marks") and the goodwill associated with these marks to the Limited and its related retail companies, nine of which are located in North Carolina.

8. The nine related retail companies operating in North Carolina are: (1) The Limited Stores, Inc.; (2) Cacique, Inc.; (3) Express, Inc.; (4) Lane Bryant, Inc.; (5) Lerner, Inc.; (6) Limited Too, Inc.; (7) Structure, Inc.; (8) Victoria's Secret, Inc.; and (9) Abercrombie & Fitch.

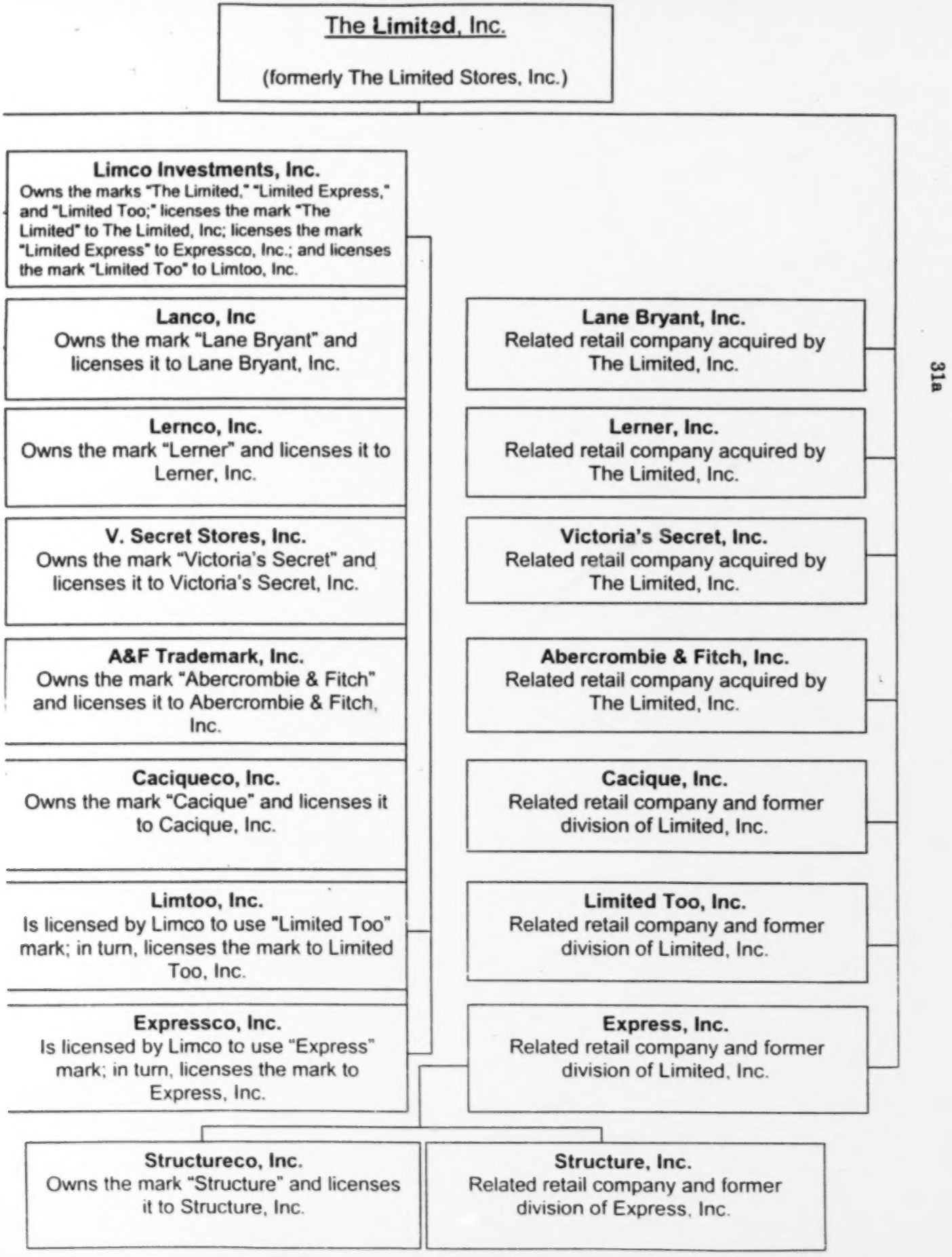
9. The nine related retail companies operating in North Carolina have over 130 retail locations in North Carolina; these companies extensively use the Taxpayers' marks at these locations.

10. The marks owned by the Taxpayers were all previously owned by either the Limited or one of the Limited's related retail companies.

11. The Taxpayers license their marks to the nine related retail companies operating in North Carolina as follows:

Taxpayer	Related Retail Company
Limco Investments, Inc.	The Limited, Inc.
Caciqueco, Inc.	Cacique, Inc.
Expressco, Inc.	Express, Inc.
Lanco, Inc.	Lane Bryant, Inc.
Lernco, Inc.	Lerner, Inc.
Limtoo, Inc.	Limited Too, Inc.
Structureco, Inc.	Structure, Inc.
V. Secret Stores, Inc.	Victoria's Secret, Inc.
A&F Trademark, Inc.	Abercrombie & Finch, Inc.

12. The structure of the Limited, the Taxpayers, and the related retail companies is illustrated on the following chart:


The Limited, Inc.
(formerly The Limited Stores, Inc.)
Limco Investments, Inc.
Owns the marks "The Limited," "Limited Express," and "Limited Too;" licenses the mark "The Limited" to The Limited, Inc; licenses the mark "Limited Express" to Expressco, Inc.; and licenses the mark "Limited Too" to Limtoo, Inc.
Lanco, Inc
Owns the mark "Lane Bryant" and licenses it to Lane Bryant, Inc.
Lernco, Inc.
Owns the mark "Lerner" and licenses it to Lerner, Inc.
V. Secret Stores, Inc.
Owns the mark "Victoria's Secret" and licenses it to Victoria's Secret, Inc.
A&F Trademark, Inc.
Owns the mark "Abercrombie & Fitch" and licenses it to Abercrombie & Fitch, Inc.
Caciqueco, Inc.
Owns the mark "Cacique" and licenses it to Cacique, Inc.
Limtoo, Inc.
Is licensed by Limco to use "Limited Too" mark; in turn, licenses the mark to Limited Too, Inc.
Expressco, Inc.
Is licensed by Limco to use "Express" mark; in turn, licenses the mark to Express, Inc.
Lane Bryant, Inc.
Related retail company acquired by The Limited, Inc.
Lerner, Inc.
Related retail company acquired by The Limited, Inc.
Victoria's Secret, Inc.
Related retail company acquired by The Limited, Inc.
Abercrombie & Fitch, Inc.
Related retail company acquired by The Limited, Inc.
Cacique, Inc.
Related retail company and former division of Limited, Inc.
Limited Too, Inc.
Related retail company and former division of Limited, Inc.
Express, Inc.
Related retail company and former division of Limited, Inc.
Structureco, Inc.
Owns the mark "Structure" and licenses it to Structure, Inc.
Structure, Inc.
Related retail company and former division of Express, Inc.

13. The Taxpayers purposefully utilize at least 130 retail locations in North Carolina to prominently display their marks, advertise apparel bearing their marks, and avail themselves of the North Carolina marketplace.

14. The Taxpayers' marks are permanently affixed to the 130 retail locations throughout North Carolina.

15. The related retail companies filed North Carolina franchise and income tax returns for the tax years January 1992 through January 1994 pursuant to G.S. 105-130 *et seq.*

16. The related retail companies reduced their North Carolina tax liability by deducting accrued royalty and interest expenses "paid" by journal entries to Taxpayers, thus producing substantial tax savings.

17. The Taxpayers accrued royalty and interest income on their books for tax years 1992 through 1994.

18. The Taxpayers did not file North Carolina franchise or income tax returns for tax years 1992 through 1994.

19. The Taxpayers did not pay any corporate income tax in Delaware or in any other state on their substantial royalty income and interest income deducted by the related retail companies.

Creation of Taxpayers

20. In its early years of operation, the Limited developed and cultivated intangible intellectual property including trademarks, tradenames, service marks, and associated goodwill.

21. Mr. Frank Colucci, Taxpayers' trademark counsel, testified that a trademark as defined under trademark law is "any name, word, symbol or device which one

manufacturer or provider of services uses to distinguish his goods or services from like goods or services of another." (T. 6/9/98, p. 232).

22. The Limited incurred substantial expenses in the development of its marks. The expenses were deducted from the Limited's gross income in the determination of its federal taxable income.

23. The Limited's North Carolina taxable income was also reduced by the expenses associated with the development of its marks because the Limited's North Carolina net income was based on its federal taxable income.

24. The value and significance of the trademark "The Limited" increased as the number of the Limited's stores increased.

25. All of the Limited's marks were registered, monitored, policed, and defended against infringement by the Limited's own in-house legal counsel prior to the formation of Taxpayers.

26. Officers of the Limited, including Mr. Kenneth Gilman, the Executive Vice-President and Chief Financial Officer of the Limited, concluded that the creation of a separate trademark holding company was the best way to protect the trademark from being "knocked off." (T. 6/9/98, p. 45).

27. The Limited's Board of Directors authorized the establishment of a separate trademark company to hold the trademark "The Limited."

28. On December 19, 1980, Articles of Incorporation were filed with the Delaware Secretary of State incorporating Limco Investments, Inc. ("Limco").

29. Limco held its first Board of Directors' meeting on January 29, 1981.

30. At this meeting, the Board authorized a tax-free exchange of assets for stock between the Limited and Limco in accordance with I.R.C. § 351, which is a common method of capitalizing subsidiaries.

31. Also on January 29, 1981, Limco issued 100 shares of its common stock, par value $1.00 per share, to the Limited for $100. In addition, the Limited made a $10,000 capital contribution to Limco.

32. The Limited became the sole shareholder of Limco.

33. By written Assignment dated January 28, 1981 The Limited assigned its marks and associated goodwill to Limco.

34. The Limited received little or no consideration for the transfer of its marks and goodwill to Limco.

35. The Limited did not have its trademark valued by a third party for a determination of the trademark's actual worth before assigning the trademark to Limco.

36. Both Limco and the Limited filed registration statements with the United States Patent and Trademark Office reporting the change in ownership of the trademark "The Limited" together with the goodwill established by the trademark from the Limited to Limco.

37. Limco did not register the trademark "The Limited" with the North Carolina Secretary of State's Office.

38. On January 29, 1981, the same day that the Limited assigned its marks and related goodwill to Limco, Limco and the Limited entered into a licensing agreement whereby Limco granted the Limited the right to use its marks in the Limited's retail operations.

39. Limco received, under the terms of the licensing agreement, royalties in the amount of 5% of the Limited's retail sales.

40. On January 29, 1981, the same day that the Limited assigned its marks and related goodwill to Limco, Limco and the Limited entered into a loan agreement whereby Limco agreed to loan the Limited money on a secured or unsecured basis, in an amount not to exceed $2,000,000. The loan agreement required the Limited to repay Limco any outstanding loan balance in 90 days and required the Limited to accrue and pay interest at the current prime rate.

41. The Limited acquired several retail establishments specializing in varying areas of apparel and began to operate these companies as wholly-owned subsidiaries. The acquired retail companies were: (1) Lane Bryant, Inc. ("Lane Bryant"), specializing in apparel for large size women; (2) Victoria's Secret, Inc. ("Victoria's Secret"), specializing in ladies' lingerie; (3) Lerner, Inc. ("Lerner"), specializing in women's apparel at a budget price; and (4) Abercrombie & Fitch, Inc. ("Abercrombie & Fitch"), specializing in upscale, casual clothing.

42. The marks owned by each of the acquired retail companies had name recognition and associated goodwill prior to acquisition of the retail companies by the Limited.

43. The Limited created separate trademark companies in a manner consistent with the tax-free creation of Limco.

44. The trademark holding company, Lanco, Inc. ("Lanco"), was incorporated in Delaware on December 15, 1982.

45. The retail company, Lane Bryant, assigned its trademark "Lane Bryant," together with the goodwill of the business symbolized by the trademark, to Lanco by a written Assignment recorded with United States Patent and Trademark Office.

46. Lane Bryant received little or no consideration from Lanco for its trademarks.

47. Lane Bryant did not have its trademark valued by a third party for a determination of the trademark's actual worth before assigning the trademark to Lanco.

48. The trademark holding company, Lernco, Inc. ("Lernco"), was incorporated in Delaware on May 2, 1985.

49. The retail company, Lerner, assigned its trademark "Lerner," together with the goodwill of the business symbolized by the trademark, to Lernco by written Assignment recorded with the United States Patent and Trademark Office.

50. Lerner did not have its trademark valued by a third party for a determination of the trademark's actual worth before assigning the trademark to Lernco.

51. Lerner received little or no consideration from Lernco for its trademarks.

52. The trademark holding company. A&F Trademark, Inc. ("A&F Trademark"), was incorporated in Delaware on February 2, 1988.

53. The retail company, Abercrombie & Fitch, assigned its trademark "Abercrombie & Fitch," together with the goodwill of the business symbolized by the trademark, to A&F Trademark by written Assignment recorded with the United States Patent and Trademark Office.

54. Abercrombie & Fitch received little or no consideration from A&F Trademark for its trademarks.

55. Abercrombie & Fitch did not have its trademark valued by a third party for a determination of the trademark's actual worth before assigning the trademark to A&F Trademark.

56. The trademark holding company, V. Secret Stores, Inc. ("V. Secret"), was incorporated in Delaware on December 1, 1988.

57. The retail company, Victoria's Secret, assigned its trademark "Victoria's Secret," together with the goodwill of the business symbolized by the trademark, to V. Secret by written Assignment recorded with the United States Patent and Trademark Office.

58. Victoria's Secret received little or no consideration from V. Secret for its trademarks.

59. Victoria's Secret did not have its trademark valued by a third party for a determination of the trademark's actual worth before assigning the trademark to V. Secret.

60. In addition to acquiring retail companies, the Limited developed its own retail companies by incorporating various business segments or divisions operated by the Limited. The retail divisions incorporated as wholly-owned subsidiaries of the Limited were: (1) Express, Inc. ("Express"), specializing in younger women's apparel; (2) Cacique, Inc. ("Cacique"), specializing in an older, more sophisticated type of lingerie; and (3) Limited Too, Inc. ("Limited Too"), specializing in clothing for young girls.

61. The trademark holding company, Expressco, Inc. ("Expressco"), was incorporated in Delaware on September 9, 1987.

62. On September 10, 1987, Expressco issued 100 shares of its common stock, par value $1.00 per share, to the trademark holding company, Limco, in exchange for $100. In addition. Limco made a $20,000 capital contribution to Expressco.

63. Also on September 10, 1987, Limco granted Expressco a non-exclusive license to use the tradename "Limited Express" or "Express" and the right to sublicense these tradenames to other companies.

64. Limco did not charge Expressco any royalty fee for the use of its mark "Express."

65. Limco did not have its trademark valued by a third party for a determination of the trademark's actual worth before licensing the trademark to Expressco.

66. The trademark holding company, Limtoo, Inc. ("Limtoo"), was incorporated in Delaware on August 1, 1991.

67. On December 31, 1991, Limtoo issued 100 shares of its common stock, par value $1.00 per share, to the trademark holding company, Limco, in exchange for $100. In addition, Limco made a $10,000 capital contribution to Limtoo.

68. Limco became the sole shareholder of Limtoo.

69. On September 9, 1991. Limco granted to Limtoo a non-exclusive license to use the trademark "Limited Too".

70. Limtoo licensed the tradename "Limited Too" from Limco, the Limited's wholly-owned subsidiary that owned the trademark.

71. Limco did not charge Limtoo any royalty fee for the use of its mark "Limited Too".

72. Limco did not have its trademark valued by a third party for a determination of the trademark's actual worth before licensing the trademark to Limtoo.

73. The trademark holding company, Structureco, Inc. ("Structureco"), was incorporated in Delaware on August 1, 1991.

74. On December 11, 1991, Structureco issued 100 shares of its common stock, par value $1.00 per share, to Express for $100. In addition, Express made a $20,000 capital contribution to Structureco.

75. Express is the sole shareholder of both Structure and Structureco.

76. On December 11, 1991, Express assigned the trademark "Structure" together with its associated goodwill to Structureco.

77. Also on December 11, 1991, Structureco licensed the tradename "Structure" to Express under the terms of a Related Company Agreement.

78. Structureco did not charge Express any royalty fee for the use of its mark "Structure".

79. Structureco did not have its trademark valued by a third party for a determination of the trademark's actual worth before licensing the trademark to Express or Structure.

80. The trademark holding company Caciqueco, Inc. ("Caciqueco") was incorporated in Delaware on August 1, 1991.

81. On September 9, 1991, Caciqueco issued 100 shares of its common stock, par value $1.00 per share, to the Limited for $100. In addition, the Limited made a $10,000 capital contribution to Caciqueco.

82. Also on September 9, 1991, the Limited assigned to Caciqueco the trademark "Cacique" together with its associated goodwill.

83. On January 1, 1991. Caciqueco licensed the trade name "Cacique" to Cacique under the terms of a Related Company Agreement.

84. The Limited did not have its trademark valued by a third party for a determination of the trademark's actual worth before assigning the trademark to Caciqueco.

85. All corporate formalities required by Delaware laws were observed in the creation of each Taxpayer.

86. Taxpayer and its corresponding related retail companies properly filed registration statements with the United States Patent and Trademark Office indicating the transfer to the Assignee of the right, title, and interest in the trademarks together with the goodwill of the business connected with the use of the marks.

87. The Taxpayers did not register their trademarks or tradenames with the North Carolina Secretary of State, relying instead on the registrations with the United States Patent and Trademark Office.

88. Upon the creation or acquisition of each Taxpayer and the tax-free assignment or grant of a license to use or sublicense the marks, each Taxpayer would license or sublicense the use of the marks back to the respective related retail company pursuant to a related company licensing agreement.

89. Each related company licensing agreement followed the format established by the original Limco licensing agreement.

90. Each related company licensing agreement entered into between a Taxpayer and the related retail company gave the related retail company a non-exclusive license to use the Taxpayer's trademarks, tradenames, service marks, and associated goodwill in its retail operations throughout the United States.

91. Each related company licensing agreement required the related retail company to pay the Taxpayer a set royalty fee based upon the related retail company's retail sales.

92. The related retail companies used Taxpayers' trademarks, tradenames, and service marks and their associated goodwill in North Carolina to promote and enhance their business in North Carolina.

93. Mr. Kenneth Gilman, President of all the Taxpayers, testified that Taxpayers' trademarks were sewn in the label of the clothes sold at the retail locations in North Carolina. (T. 6/9/98, p. 75).

94. The Taxpayers' marks were used by the related retail companies located in North Carolina in their store layout, their merchandising, and their advertising.

95. The Taxpayers' ownership of the marks did not affect the use of the marks in North Carolina in the eyes of the public consumer who continued to purchase apparel from the retail locations and who were unaware that the marks had been assigned to Taxpayers.

96. Mr. Kenneth Gilman testified that there were no changes in the relationship of the customer and the related retail companies as a result of the assignment of the marks to Taxpayers. (T. 6/9/98, pp. 149-150).

97. Mr. Kenneth Gilman testified that as long as a related retail company operated in accordance with the licensing agreements, the day-to-day operations of the related retail company did not change with the creation of Taxpayers and the assignment of the marks. (T. 6/9/98, pp. 148-149).

98. Neither the Taxpayers nor any of the related retail companies made any public announcements notifying the public of either the formation of Taxpayers or the assignment of the marks to Taxpayers.

99. The shareholders of the Limited were not notified that the marks and the goodwill associated with the marks had been assigned to Taxpayers.

100. Employees of the related retail companies were not notified that the marks and goodwill associated with the marks had been assigned to Taxpayers.

101. After the assignment of the marks, Taxpayers depended upon the same consumer recognition and customer loyalty for the production of their income that had existed prior to the transfer of the marks.

102. At no time during the audit period did the Limited's annual reports or its Form 10-Ks disclose the formation of Taxpayers or the transfer to Taxpayers of marks valued at approximately $1.2 billion dollars.

103. The Limited's January 30, 1993, Form 10-K included a footnote "A," which reads: "[T]he names of certain subsidiaries are omitted since such unnamed subsidiaries considered in the aggregate as a single subsidiary would not constitute a significant subsidiary as of January 30, 1993."

104. The Taxpayers were not listed as subsidiaries of the Limited on the January 30, 1993 Form 10-K.

105. Mr. Kenneth Gilman testified that the intercompany transactions occurring during the audit period between Taxpayers (producing over $1 billion in income) and the related retail companies (producing over $203 million in losses) were not significant enough to be disclosed in the footnotes of the Limited's annual report financial statements. (T. 6/9/98, pp. 117-123).

Organization of Taxpayers

106. Each of the Taxpayers elected a Board of Directors, the composition of which changed from time to time during the audit period.

107. The Board of Directors was generally the same for each Taxpayer.

108. The Taxpayers' Board of Directors consisted of Mr. Kenneth Gilman, President, Mr. Louis Black, an attorney, Mr. Roger Thompson, a banking executive, and Mr. Edward Jones, an accountant from Delaware Corporate Management.

109. Mr. Kenneth Gillman testified that he did not believe that he had attended a board meeting of the Taxpayers in over 10 years. (T. 6/9/98, p. 160).

110. Mr. Kenneth Gillman testified that he delegated his responsibilities as board member of the Taxpayers to Mr. Tim Lyons, Vice-President of Taxes for the Limited. (T. 6/9/98, pp. 56-57).

111. The Taxpayers compensated Board members not associated with the Limited for board meetings attended but did not compensate the Board members directly employed by the Limited.

112. Mr. Kenneth Gilman testified that neither he nor Mr. Tim Lyons as executives of the Limited were

permitted to receive compensation for services performed for any subsidiary of the Limited. (T. 6/9/98, p. 125).

113. Mr. Louis Black testified that each of Taxpayers' boards on which he served compensated him fifty dollars ($50) for each board meeting attended. (T. 6/9/98, pp. 208-209).

114. The Taxpayers' expenses associated with the compensation of board members averaged $600 per year per Taxpayer.

115. The Taxpayers' Board of Directors met quarterly and they discussed such things as royalty rates, interest rates, and the authorized lending limits between the Taxpayers and the related retail companies.

116. The Taxpayers' board members authorized increased lending limits for the related retail companies as needed when the balance of the related retail companies' outstanding notes receivable reached authorized lending limits.

117. The Taxpayers' Board of Directors meetings were held at Mr. Louis Black's office, not at the Taxpayers' leased office space.

118. The Taxpayers' corporate records, such as minutes, charters, and by-laws, were kept in Mr. Louis Black's office, not at the Taxpayers' leased office space.

119. The Taxpayers held annual stockholders' meetings as required by Delaware law and adopted appropriate resolutions, including the election of officers and directors.

120. The Taxpayers' officers or board members did not prepare yearly business plans for the operations of Taxpayers.

121. The Taxpayers did not own or lease any real property or any tangible personal property in any state except Delaware.

122. The Taxpayers subleased shared office space from Delaware Corporate Management in a building located in Delaware.

123. The Taxpayers shared office equipment and office supplies.

124. The Taxpayers' primary office address was 1105 Market Street, Delaware; approximately 670 companies not related to the Limited or its wholly-owned subsidiaries list this same address as their primary office address.

125. Mr. Louis Black testified that an employee of Delaware Corporate Management doing work for or on behalf of Taxpayers used Taxpayers' subleased office space, "if they [were] used by anyone at all." (T. 6/9/98; p. 227).

126. The Taxpayers' rental expense associated with the subleased office space in Delaware approximated $240 per year for each Taxpayer.

127. The subleased office space was not permanently assigned to Taxpayers, but instead was rotated much like a time share-arrangement.

128. The Taxpayers hired no employees in any state.

129. The Taxpayers outsourced all of their accounting, legal, banking and administrative services.

130 The law of [sic] firm of Morris, Nichols, Arsht & Tunnel, of which Mr. Louis Black was a partner, was hired as legal counsel for Taxpayers.

131. Delaware Corporate Management, of which Mr. Ed Jones was an employee, was hired as Taxpayers' accounting firm.

132. As board member and principal executive in charge of Taxpayers' accounting services, Mr. Ed Jones was limited to signing checks not to exceed $500.

133. The Taxpayers contracted with Mr. Frank Colucci of the firm Colucci & Umans as their trademark counsel.

134. The Taxpayers maintained checking accounts in their own names.

135. The Taxpayers used their checking accounts to pay operating expenses such as legal and accounting bills.

136. The Taxpayers did not incur substantial ordinary and necessary business expenses such as postage, telephone, or utilities for their business operations in Delaware.

137. The Taxpayers contracted with Delaware Corporate Management, a "nexus service provider" to perform services on their behalf in Delaware.

138. Services performed by Delaware Corporate Management for the Taxpayers included: (1) providing officers and directors located in the State of Delaware; (2) providing office space; (3) mail forwarding; (4) filing annual Delaware Franchise Tax Returns; (5) maintaining the operating checkbook; and (6) scheduling use of a shared conference room.

Operations of the Taxpayers

139. The Taxpayers' Board of Directors agreed to license their marks to the related retail companies pursuant to licensing agreements.

140. The Taxpayers' trademark counsel, Mr. Frank Colucci, assisted in drafting licensing agreements between the Taxpayers, as licensor, and the related retail companies, as licensees.

141. Mr. Frank Colucci testified that all of the Taxpayers' licensing agreements were basically the same in terms of the legal requirements imposed on both the licensee and licensor. (T. 6/9/98, p. 243).

142. Each licensing agreement granted the related retail company a non-exclusive license to use all of the Taxpayer's marks in its retail operations.

143. The terms of each licensing agreement required the related retail company to pay a royalty fee of between 5% and 6% of its retail operating gross sales to Taxpayers in return for continued use of the marks.

144. Each licensing agreement allowed the related retail company to continue using the Taxpayer's name in conducting its business in the same manner as before the creation of the Taxpayer.

145. Initially, the royalty rates charged by the Taxpayers to the related retail companies were estimated by Taxpayers' trademark counsel based upon his knowledge of licensing agreements between unrelated third parties and what he believed to be a reasonable royalty based on a fair, arms-length transaction.

146. Dr. Irving Plotkin, the Taxpayers' expert witness, testified that: "When you deal with a transaction between a related party, the transaction itself is not arm's length. It cannot be – it could not have come about by an arm's length negotiation." (T. 6/11/98, pp. 68-69).

147. Dr. Plotkin testified that: "The [intercompany] agreement should have never been described as an arm's length agreement, because [it] couldn't have been." (T. 6/11/98, p. 70).

148. The Taxpayers eventually solicited trademark valuation studies from third parties, which they used to establish the royalty rate, charged.

149. The Taxpayers were required on occasion to amend the royalty rates charged to the related retail companies to correspond with the royalty rates determined by the third party valuation studies.

150. The values of the marks as determined by the trademark valuation reports were dependent upon the "on-going" retail operations of the related retail companies.

151. The royalty rate charged to the related retail companies as determined by the trademark valuation reports was between 5% and 6%.

152. The Taxpayers were completely dependent upon the operations of the related retail companies, including the ones located in North Carolina, for the production of their income because the royalty rates charged by the Taxpayers were based on a percentage of the related retail companies' operating sales.

153. A royalty fee was not charged for the use of the marks when a license or sublicense agreement was entered into between two Taxpayers.

154. Neither the Limited nor any of its subsidiaries licensed or sublicensed marks to foreign subsidiaries.

155. The Taxpayers' Profit and Loss Statements for the years at issue did not include any foreign source royalty income.

156. Royalty income received from foreign subsidiaries is considered gross income and fully taxable for federal corporate income tax purposes pursuant to I.R.C. § 951.

157. The only time the Taxpayers, as licensors, charged a royalty fee for the use of their marks to an affiliated company, as a licensee, was when a state tax benefit could be obtained by the licensee.

158. Each licensing agreement entered into between a related retail company, as licensee, and a Taxpayer, as licensor, required the related retail company to make quarterly royalty payments for the use of the trademarks.

159. The related retail companies did not pay the royalty fees to Taxpayers or tender any cash remittances to Taxpayers in settlement of the royalties charged.

160. Each related retail company accrued a royalty expense deduction based on a percentage of sales.

161. Mr. Kenneth Gilman testified that the royalty payments due under the licensing agreements were made by accounting journal entry. No checks were written nor were there any physical transfers of funds between the parties. The related retail companies therefore "paid" their royalty fees to Taxpayers via accounting journal entries. (T. 6/9/98, p. 93).

162. The North Carolina taxable income of each of the related retail companies was significantly reduced by the deduction of accrued royalty expenses.

163. The Taxpayers accrued but never received payment for royalties from the respective related retail companies.

164. The accrued royalty receivables for each of the Taxpayers increased on a yearly basis corresponding closely to the amount of accrued royalty payables recorded on the books of the related retail companies.

165. The related retail companies' accrued royalty receivables were never collected.

166. The Taxpayers paid no state income tax to Delaware or any state on the accrued royalty receivables.

167. The Taxpayers' expenses were miniscule in relation to their accrued income. For example, Limco's total expenses for the three years at issue were $729,175, which is 0.2% of its total accrued income of $311,952,574 during the same period. Of Limco's total expenses, legal expenses alone equaled $687,754 or 94.32% of total expenses.

168. Limco's remaining expenses of $41,421 for the three years at issue were immaterial and are summarized as follows: (1) Delaware franchise fees – $150; (2) accounting services – $31,052; (3) telephone expenses – $1,102; (4) rental expenses – $ 720; (5) Director's fees – $2,300; (6) custodial expenses to Delaware Trust Management – $3,520; (6) depreciation expenses – $1,862; (7) other miscellaneous expenses – $714.

169. The Taxpayers neither declared nor paid a dividend to the Limited or to any of the related retail companies during the audit period.

170. The Taxpayers entered into loan agreements whereby Taxpayers loaned their excess operating funds to the related retail companies in the form of notes receivable.

171. Mr. Kenneth Gilman testified that the primary source of lending to the related retail companies was the earnings of Taxpayers. (T. 6/9/98, pp. 105-106).

172. Mr. Louis Black testified that Taxpayers earned their money by charging the related retail companies royalties for the use of Taxpayers' marks and by receiving interest through loaning the related retail companies money. (T. 6/9/98, p. 179).

173. The Taxpayers' Board of Directors, including Mr. Louis Black, authorized loans to the related retail companies in amounts comparable to the cumulative amount of royalties the related retail companies accrued during the tax year.

174. Despite authorizing loans to the related retail companies in excess of $100 billion, Taxpayers' Board Member, Mr. Louis Black, testified that he had not reviewed the Limited's 10-K or its annual reports. (T. 6/9/98, p. 201).

175. The notes, which were generally 180-day promissory notes, contained standard provisions such as loan amount, interest rate, due date, and names of the parties.

176. All notes bore a market rate of interest.

177. The Taxpayers earned interest income on the notes to the related retail companies.

178. The related retail companies did not pay any outstanding principal or interest on the notes to the Taxpayers during the audit period.

179. The related retail companies accrued an interest expense deduction on their outstanding notes receivable.

180. The interest charges were settled by accounting journal entries.

181. As notes matured, the Taxpayers made the required journal entries and issued new notes to the related retail companies.

182. The Taxpayers' Board of Directors increased the authorized lending limits of the related retail companies once the related retail companies' outstanding notes receivable balances reached authorized limits.

183. The notes receivable contained no mechanism by which the Taxpayers could collect the loan debt from the related retail companies.

184. The Taxpayers made no attempt at collecting the outstanding notes receivable during the audit period.

185. The Taxpayers instructed their custodian, Wilmington Trust, to make no attempt to collect the outstanding notes.

186. The Taxpayers' Yearly Statements of Account reflecting the asset value of Taxpayers' outstanding notes were marked "Notes – Do Not Collect."

187. The Taxpayers did not loan money to or borrow money from any unrelated third party.

188. The North Carolina taxable income of the related retail companies was reduced by the deduction of the accrued royalty and interest expenses that were never paid.

189. The Taxpayers paid no state income tax to Delaware or any state on the royalty or interest income.

190. The Taxpayers earned 100% of their ordinary gross income from two sources: (1) the royalties charged to the related retail companies for the use of Taxpayers'

marks and (2) interest earned from outstanding loans issued to the related retail companies.

191. The Taxpayers recorded royalty income totaling $957,442,830 and interest income totaling $236,728,978 from the related retail companies for the tax years at issue, broken down as follows:

YEAR	ROYALTY INCOME	INTEREST INCOME
1/92	$298,494,228	$ 58,610,029
1/93	349,880,983	56,087,605
1/94	301,067,619	122,031,344
TOTAL	**$ 949,442,830**	**236,728,978**

192. Pursuant to I.R.C. § 1501, the Taxpayers filed a consolidated federal income tax return with their parent, the Limited, for tax years ended January 1992, January 1993, and January 1994.

193. The intercompany royalty and interest transactions that occurred between Taxpayers and the related retail companies had no tax effect on the federal taxable income of the Limited because of required intercompany eliminations.

194. The intercompany royalty and interest transactions that occurred between Taxpayers and the related retail companies significantly decreased the North Carolina taxable income of the related retail companies.

The Licensing Agreements

195. The Taxpayers had incurred none of the costs and had performed none of the activities that, in any manner, had created, enhanced, or protected the value of the marks prior to the assignment of the marks to Taxpayers.

196. "Naked assignment" is a term used in trademark law that describes the assignment of a trademark without its associated goodwill.

197. Mr. Frank Colucci, Taxpayers' trademark counsel, testified that it is illegal in the United States to assign trademarks without assigning the goodwill associated with the trademarks. (T. 6/9/98, p. 279).

198. Mr. Frank Colucci testified that goodwill is an accumulation of everything that the public perceives about a trademark – good, bad, or indifferent (T. 6/9/98, p. 280).

199. Mr. Frank Colucci testified that the goodwill the Taxpayers' assigned to the related retail companies had been created by the related retail companies. (T. 6/9/98, p. 280).

200. Mr. Frank Colucci testified that, after the assignment of the marks to the Taxpayers, the only way to maintain the goodwill associated with the marks was to use the marks. Mr. Frank Colucci stated that, "You use the trademark and, through the use of the trademark, you either maintain the goodwill or you don't maintain the goodwill." (T. 6/9/98, p. 280).

201. Mr. Frank Colucci testified that the trademarks were used by the related retail companies wherever they had stores and businesses. (T. 6/9/98, p. 280).

202. If Taxpayers did not take appropriate measures to monitor the related retail companies' use of their marks, Taxpayers risked abandonment of their marks, thereby enabling third parties to use the marks in whatever manner they desired.

203. The trademark law concept of "naked licensing" requires the owner of a trademark that permits another company to use its trademark to ensure that

the public is not deceived with respect to the nature and quality of the goods sold under the mark.

204. Mr. Frank Colucci testified that a licensing agreement is the contractual basis by which the licensor of a trademark or tradename controls the nature and quality of the goods and services sold by a licensee using the trademark or tradename. (T. 6/9/98, p. 241).

205. Mr. Frank Colucci testified that a court could invalidate a mark and refuse to enforce a mark if the owner of the mark does nothing to protect the public trust with respect to the nature and quality of the goods sold under the mark. (T. 6/9/98, p. 237).

206. Mr. Frank Colucci testified that "the whole idea of having a related company [licensing agreement is] that there be controls over an *agent* quality of the goods . . . so that the public being accustomed with a mark being used on one line of goods or services, now that it was given to another company, would not be confused or deceived." (emphasis added) (T. 6/9/98, pp. 236-237).

207. The Taxpayers relied upon the related retail companies to ensure that the public was not deceived with respect to the nature and quality of goods sold under Taxpayers' marks.

208. The Taxpayers, owners of the marks, controlled the use of the marks in North Carolina and the nature and quality of goods sold under the marks by the related retail companies in North Carolina.

209. The related retail companies performed activities in North Carolina on behalf of the Taxpayers, including the following: (1) the preparation of quarterly inspection reports regarding the activities of the retail location; (2) establishment of store layout and design;

(3) selecting the merchandise that would bear Taxpayers' marks; (4) regularly advertising apparel and merchandise in this State bearing Taxpayers' marks; (5) inspecting merchandise bearing Taxpayers' marks; (6) reporting trademark violations; and (7) establishing and maintaining Taxpayers' economic market in North Carolina.

210. The activities performed in North Carolina on behalf of the Taxpayers were significantly associated with Taxpayers' ability to establish and maintain a market in North Carolina.

211. Mr. Kenneth Gilman testified that: "[I]t's important to protect the trademark because it's the identity of the company. It's one of the ways that you differentiate what you are as a company and what you represent; what you're selling; what you're trying to accomplish in a commercial marketplace from other people." (T. 6/9/98, p. 71).

212. The Taxpayers' commercial marketplace was in part located in North Carolina.

213. The Taxpayers' marks were displayed on the North Carolina retail locations of the related retail companies.

214. The related retail companies' activities, including marketing products bearing Taxpayer's trademarks and tradenames, maintaining the quality of the apparel sold under Taxpayers' marks, and otherwise providing retail customers with a quality shopping experience, inures to and enhances the value of Taxpayers' trademarks and tradenames in North Carolina.

215. Mr. Frank Colucci testified that he monitored "how the trademarks [were] used by the retailers" in his capacity as trademark counsel for both Taxpayers

and the related retail companies. (T. 6/9/98, pp. 254-255).

216. Mr. Frank Colucci testified that representatives of the retailers as well as representatives of Taxpayers sent Mr. Frank Colucci or Mr. Frank Colucci's staff into the retail stores to monitor the use of Taxpayers' trademarks by the related retail companies. (T. 6/9/98, p. 260).

217. The Taxpayers, as owners of the marks, had the power to determine which retail companies used their marks and where they could be used.

218. The Taxpayers, as owners of the marks, had the power to control to whom the marks were licensed, what license fees were charged, and when the licensing agreements expired.

219. The Taxpayers, as owners of marks, had the right to dictate the manner in which the trademarks and tradenames were displayed at the retail locations throughout North Carolina.

220. The Taxpayers knowingly and purposefully granted the retail companies a license to use their marks in connection with retail operations worldwide, including in North Carolina.

221. The licensing agreements provided that all products sold by the related retail companies bearing Taxpayers' trademarks and tradenames had to be consistent with the high standards of quality and excellence established over the years by the related retail companies with respect to their trademarks and tradenames.

222. Sections 2.1 through 2.3 of the licensing agreements provided that Taxpayers' trademarks or tradenames had to be used by the related retail companies in accordance with the following terms and conditions: (1) the retailer would use its best efforts, skill, and

diligence in the operation of its Stores, and would regulate its employees so that they will be courteous and helpful to the public; (2) the retailer would use its best efforts, skill, and diligence to ensure that the quality of all apparel sold under or in connection with the trademark or tradenames would not be less than the standard of quality previously established by the retail companies; and (3) the retailer would operate its stores in accordance with reasonable business standards and would provide a standard of service not less than the standard of quality previously established by the retail companies.

223. Section 3.1 of the licensing agreements provided that each retail store operated by a related retail company had to inspect the store at least once each year and had to notify Taxpayers of the inspections in a written statement verifying that the inspections took place.

224. The Taxpayers did not physically inspect any stores in North Carolina and rarely, if ever, visited any store outside of Delaware.

225. Store employees at the North Carolina retail locations of the related retail companies acted as quality assurance inspectors and performed all inspections of apparel bearing Taxpayers' marks to ensure the quality of the goods sold under Taxpayers' marks in North Carolina.

226. The North Carolina retail operating store employees, in their capacity as quality assurance inspectors, prepared inspection reports based on the operations of the related retail companies in this State.

227. Mr. Kenneth Gilman testified that the employees of the related retail companies performed inspections of the stores located in North Carolina in order to

adhere to quality standards mandated by the licensing agreements and to demonstrate compliance with the licensors' requirements. (T. 6/9/98, pp. 86-88).

228. Section 3.1.2 of the licensing agreements provided that the related retail companies were responsible for, at their own cost and expense, correcting any deficiencies found in the quality of the products sold bearing Taxpayers' trademarks.

229. Section 4 of the licensing agreements provided that the related retail companies had to make available to Taxpayers samples of all advertising or other literature, packages, and labels bearing Taxpayers' tradename or trademarks.

230. Mr. Frank Colucci testified that he monitored all advertising associated with Taxpayers' trademarks and tradenames in his capacity as trademark counsel for both the related retail companies and Taxpayers. (T. 6/9/98, pp. 254-255).

231. In reviewing the advertising samples submitted by the related retail companies, Mr. Frank Colucci looked to ensure that Taxpayers' marks were used in a consistent manner and to ensure that the use did not infringe on other marks.

232. Section 11.1 of the licensing agreements required the related retail company to defend Taxpayers' marks against infringement by third parties at its own cost and expense.

233. Section 11.2 of the licensing agreements provided that if the related retail company was made party to a legal proceeding based upon a claim that one of Taxpayers' marks infringed upon a third party's mark, the related retail company had to, at its own cost and expense, defend its use of the licensed mark.

234. Prior to the formation of Taxpayers, the marks associated with the related retail companies were registered, monitored, and defended against infringement by the related retail companies themselves.

235. The Taxpayers continually updated the trademark filings and registrations with the United States Patent and Trademark Office in order to ensure that Taxpayers' rights in the marks were preserved.

236. Mr. Frank Colucci testified that his office filed with the United States Patent and Trademark Office every six years an affidavit "saying that [the] trademarks [were] still in use. Otherwise, [the trademarks would] be automatically cancelled." (T. 6/9/98, pp. 262-263).

237. Mr. Kenneth Gilman, President of the Limited, testified that the related retail companies located in North Carolina used Taxpayers' marks on a daily basis. (T. 6/9/98, pp. 74-75).

The Assessments

238. The Limited was contacted in March, 1995 by Mr. Al Milak, Revenue Field Auditor in the Interstate Audit Division, regarding the activities of the Limited and its affiliates in this State.

239. An on-site audit for corporate franchise and income tax was conducted in August 1995.

240. The auditors determined that Taxpayers, subsidiaries of the Limited, were doing business in this State and subject to corporate income and franchise taxation in this State pursuant to G.S. 105-114, 105-122, 105-130.1, and 105-130.3.

241. The Taxpayers were not filing corporate franchise and income tax returns.

242. The auditor requested on October 23, 1995 that Taxpayers file and pay North Carolina franchise and income tax, apportioning their income liability to this State as an excluded corporation pursuant to G.S. 105-130.4(a)(4) and 105-130.4(r).

243. The Taxpayers did not voluntarily file North Carolina franchise and income tax returns and refused to provide the auditors with sufficient information necessary to compute Taxpayers' North Carolina corporate liability.

244. Jeopardy assessments of corporate income and franchise taxes were issued for tax years January 1992, January 1993, and January 1994 under the authority of G.S. 105-241.1(g) on March 26, 1996 and on April 2, 1996.

245. The Taxpayers were assessed income and franchise taxes calculated on royalty and interest income derived from sources within North Carolina.

246. For each Taxpayer during the audit period, the franchise assessments of tax, penalties, and interest are as follows:

Franchise Tax Assessments	
A&F Trademark, Inc.	$ 3,963
Caciqueco, Inc.	$ 1,025
Expressco, Inc.	$ 37,264
Lanco, Inc	$ 37,296
Lernco, Inc.	$ 31,949
Limco Investments, Inc.	$ 124,966
Limtoo, Inc.	$ 44,142
Structureco, Inc.	$ 1,071
V. Secret Stores, Inc.	$ 27,176
Total	**$ 308,852**

247. For each Taxpayer during the audit period, the corporate income tax assessments of tax, penalties, and interest are as follows:

Income Tax Assessments	
A&F Trademark, Inc.	$ 116,401
Caciqueco, Inc.	$ 58,452
Expressco, Inc.	$ 953,765
Lanco, Inc	$ 580,231
Lernco, Inc.	$ 766,775
Limco Investments, Inc.	$ 1,331,052
Limtoo, Inc.	$ 128,766
Structureco, Inc.	$ 82,479
V. Secret Stores, Inc.	$ 666,909
Total	**$ 4,684,830**

248. The jeopardy income tax assessments were based on the best information available to the auditor. That information was Taxpayers' separate entity, "pro-forma" federal taxable income, Federal Line 28, as reflected on the Limited's consolidated 1120 tax return.

249. The proposed assessments were based on the State's assertion that Taxpayers were doing business in North Carolina by virtue of their activities of licensing intangibles for use in North Carolina and using in-state representatives in furtherance of their business activities.

250. On April 22, 1996, Taxpayers timely protested the proposed corporate income and franchise tax assessments and reserved the right to a hearing before the Secretary of Revenue.

251. An application for hearing was timely filed on August 18, 1997.

252. An Administrative Tax Hearing before the Secretary of Revenue was conducted by the hearings' officer on Monday, June 9 through Wednesday, June 11, 1998 in the Revenue Building on 501 North Wilmington Street.

253. On June 11, 1998, the hearings' officer granted Taxpayers' motion to waive all penalties associated with all three-tax years at issue.

CONCLUSIONS OF LAW

The Board reviewed the following conclusions of law made by the Assistant Secretary in his final decision:

1. The Taxpayers are subject to corporate income taxation in this State pursuant to G.S. 105-130 *et seq.*

2. The Taxpayers are subject to franchise taxation in this State pursuant to G.S. 105-114 *et seq.*

3. G.S. 105-130.3 imposes a tax upon the State net income of every C corporation doing business in this State.

4. The Taxpayers are C corporations.

5. G.S. 105-122 imposes a franchise tax upon every corporation domesticated under the laws of this State or doing business in this State.

6. The Taxpayers are not domesticated under the laws of this State.

7. For franchise tax purposes, "doing business" is defined as "[e]ach and every act, power or privilege exercised or enjoyed in this State, as an incident to, or by virtue of the powers and privileges granted by the laws of this State."

8. North Carolina Administrative Rule 17 NCAC 5C .0102 was promulgated by the Secretary of Revenue under authority of G.S. 105-262 and 105-264 to interpret G.S. 105-130.3.

9. Administrative Rule 17 NCAC 5C .0102 is *prima facie* correct.

10. Administrative Rule 17 NCAC 5C .0102 defines "doing business," in pertinent part, as "the operation of any business enterprise or activity in North Carolina for economic gain, including, but not limited to . . . the owning, renting, or operating of business or income-producing property in North Carolina including, but not limited to . . . [t]rademarks [and] tradenames."

11. The Taxpayers own intangible property in the form of trademarks, tradenames, and service marks and the goodwill associated with these marks.

12. There is no such thing as property in a trademark except as a right appurtenant to an established business or trade in connection with which the mark is employed.

13. A trademark has no independent significance apart from the goodwill it symbolizes; if there is no established business and no goodwill, a trademark symbolizes nothing.

14. A trademark cannot exist apart from the going business in which it is used.

15. Trademark rights are wholly dependent upon actual use.

16. The actual use of a symbol as a trademark in the sale of goods creates and builds up rights in a mark.

17. Lack of actual use can result in loss of legal rights in the mark, known as "abandonment."

18. The Taxpayers licensed their intangible property, in the form of trademarks, tradenames, service marks and associated goodwill, to the related retail companies for use in this State.

19. If a trademark owner licenses the mark, the owner must control the nature and quality of the goods sold under the mark and must at all costs avoid deceiving the public.

20. The concept of quality control has been incorporated into the Lanham Act by the "related company" doctrine.

21. Under the Lanham Act, a "related company" is "any person whose use of the mark is controlled by the owner of the mark with respect to the nature and quality of the goods or services on or in connection with which the mark is used."

22. If the owner controls the use of the mark by the licensee, the owner obtains the benefits of Section 5 of the Lanham Act, and the licensee's use of the mark is attributed to and inures to the benefit of licensor, the owner of the mark.

23. If the owner of a trademark does not exercise sufficient actual control over the use of the mark by the licensee, the owner loses its rights in the mark through abandonment.

24. The trademark owner must exercise *actual* control over the licensee's use of the mark. Mere paper control, such as a quality control provision in a licensing agreement, without actual control is insufficient. The mere legal right to control is insufficient, as is the voluntary exchange of information.

25. Under the related company doctrine, if the Taxpayers exercised sufficient actual control over the operations of the related retail companies in North Carolina with regard to their use of the marks and the nature and quality of the goods sold under the marks, the use by the related retail companies in North Carolina is attributed to and inures to the benefit of the Taxpayers.

26. Absent sufficient actual control by the Taxpayers over the related retail companies' use of the marks in North Carolina and the nature and quality of the goods sold under the marks in this State, the use of the marks by the related retail companies is not attributed to the Taxpayers.

27. If use by the related retail companies of Taxpayers' marks is not attributed to Taxpayers, the marks would be abandoned.

28. The licensing agreements between Taxpayers and the related retail companies created a contractual agency relationship between Taxpayers and the related retail companies.

29. The Taxpayers exercised actual control over the licensees' use of the marks at the 130 North Carolina retail locations and over the nature and quality of the goods sold under the marks by the licensees at these locations.

30. The related retail companies are "related retail companies" under the related company doctrine of trademark law.

31. The related retail companies regularly and systematically used the Taxpayers' marks at the 130 retail locations in North Carolina.

32. The intangibles owned by the Taxpayers and used at the 130 retail locations in this State have acquired a business situs in North Carolina.

33. The Taxpayers own income-producing property in North Carolina.

34. The regular and systematic use of the Taxpayers' marks by the related retail companies at the 130 retail locations in North Carolina is attributed to and inures to the benefit of Taxpayers, thereby protecting and preserving the value and existence of the marks and associated goodwill, Taxpayers' only assets.

35. The use of Taxpayers' marks by the related retail companies in North Carolina is essential to the continued existence of the marks.

36. The quality control and trademark protection activities performed by employees of the related retail companies in North Carolina to protect Taxpayers' marks are attributed to and inure to the benefit of Taxpayers.

37. The activities performed by employees of the related retail companies in North Carolina to assist in maintaining the goodwill associated with Taxpayers' marks are attributed to and inure to the benefit of Taxpayers.

38. The related retail companies, in performing the activities of quality control and protection and preservation of Taxpayers' marks and associated goodwill, act as Taxpayers' agents or representatives in North Carolina.

39. The activities of the related retail companies, acting as Taxpayers' agents or representatives, enable Taxpayers to maintain and enhance a market in this State for merchandise bearing Taxpayers' marks.

40. The Taxpayers' primary source of income, the royalty fees, is dependent upon business activity conducted by employees of the related retail companies in North Carolina, which activity Taxpayers control.

41. The Taxpayers purposefully availed themselves of the benefits of an economic market in North Carolina.

42. The Taxpayers regularly and systematically exploited the North Carolina marketplace for economic gain.

43. The Taxpayers' business activities were purposefully directed towards residents of North Carolina.

44. The Taxpayers operate income-producing business property in North Carolina.

45. The Taxpayers are operating a business activity or enterprise in this State for economic gain.

46. The Taxpayers are "doing business" in this State for corporate income tax purposes.

47. The Taxpayers are "doing business" in this State for corporate franchise tax purposes.

48. The Taxpayers received more than 50% of their income from investments in or dealing in intangible property.

49. The Taxpayers are "excluded corporations" under G.S. 105-130.4(a)(4).

50. The Taxpayers must apportion their business income using the sales factor as determined under G.S. 105-130.4(a)(1).

51. The proposed assessments of corporate income and franchise tax were proper under G.S. 105-241.1.

DECISION

Taxpayers have petitioned this Board for administrative review of the final decision issued by the Assistant Secretary on September 19, 2000 sustaining the assessment of corporate franchise and income tax for Taxpayers' fiscal year ended January 31, 1994. The scope of administrative review for petitions filed with the Tax Review Board is governed by G.S. 105-241.2(b2). After the Board conducts an administrative hearing, this statute provides in pertinent part: "the Board shall confirm, modify, reverse, reduce or increase the assessment or decision of the Secretary."

When reviewing the Assistant Secretary's Final Decision, the Board must determine, based upon the record, whether the Assistant Secretary properly concluded: (1) that the Taxpayers were "doing business" in this State within the meaning of G.S. 105-130.3 and G.S. 105-114 so as to be subject to the corporate income and franchise tax; and (2) that the Taxpayers were "excluded corporations" within the meaning of G.S. 105-130.4(a)(4).

The Taxpayers' principle arguments for reverse of the Assistant Secretary's Final Decision were: (1) until the recent enactment of legislation, the statute did not authorize taxation of the Taxpayers, (2) physical presence in a state is a constitutional prerequisite for taxation; and (3) since the Taxpayers are not physically present in North Carolina they cannot be taxed by North Carolina. Taxpayers' subsidiary arguments include: (1) no agency relationships exist between the Taxpayers and the related retail entities to which they have licensed their tangible property; and (2) Taxpayers are not "excluded corporations" under G.S. 105-130.4(a).

Upon review of the record, the facts show that Taxpayers are nine wholly-owned subsidiaries of the Limited Stores, Inc. (the "Limited") an Ohio corporation. The Limited also owns 100% of eight retail companies. Those companies are: Lane Bryant, Inc.; Lerner, Inc.; Victoria's Secret, Inc.; Cacique, Inc.; Abercrombie & Fitch, Inc.; Limited Too, Inc.; Express, Inc.; and Structure, Inc. The Limited and the wholly-owned eight retail subsidiaries are doing business in North Carolina and pay corporate income and franchise taxes here. During the year at issue, the Limited and the eight retail subsidiaries operated over 130 retail locations in North Carolina.

Taxpayers were incorporated in Delaware to hold the trademarks owned by the Limited and the related retail companies. The marks owned by the Taxpayers include "The Limited," "Limited Too," "Victoria's Secrets," "Express," "Structure," "Cacique," "Abercrombie and Fitch," "Lane Bryant," and "Lerner." The marks are a form of intangible personal property. The Taxpayers do not own or lease any real property or tangible personal property in any state except Delaware. The Taxpayers have no employees in any state. The Taxpayers received the marks they own in separate I.R.C. Section 351 tax-free exchanges with the related retail companies. In these exchanges, the related retail companies transferred the marks to the Taxpayers for little or no consideration. The Taxpayers then entered into a licensing agreement with the corresponding related retail companies. The licensing agreements authorized the related retail companies to continue to use the marks they had previously owned in exchange for royalty payments to the Taxpayers. These agreements required the retail stores to pay Taxpayers a royalty fee based on the percentage of the retail companies' gross

sales. The Limited and the related retail companies deducted these royalty payments from their income for North Carolina tax purposes. Taxpayers then loaned these royalty payments back to the related companies for use in their retail operations. Taxpayers charged the retail companies a market rate of interest, which generated further deductions for the related retail companies. Taxpayers did not pay any income tax to any state on any of the income received from the related retail companies. For the year at issue (1994), Taxpayers recorded $301,067,619 in royalty income and $122,031,344 in interest income from the related retail companies. This accounted for 100% of Taxpayers' income. The net effect of both of these separate transactions upon each related retail company was to significantly reduce the company's taxable income in the states in which it did business by both the royalty payment and the interest expense charged by the Taxpayers.

This Board notes that G.S. 105-122 imposes a franchise tax on every corporation incorporated, domesticated or doing business in this State. For franchise tax purposes, "doing business" is defined as [e]ach and every act, power, or privileges granted by the laws of this State." (See G.S. 105-114(b)(3).) G.S. 105-130.3 imposes a tax upon the State net income of every C corporation doing business in the State. Although the term "doing business" is not defined by statute for corporate income tax purposes, the Secretary has promulgated an administrative rule defining this term. G.S. 105-262 and G.S. 105-264 authorize the Secretary to adopt administrative rules interpreting all laws he administers. Administrative Rule 17 NCAC 5C .0102 provides, in pertinent part, that the term 'doing business' means the operation of any business enterprise

or activity in North Carolina for economic gain, including, but not limited to . . . . . the owning, renting or operating of business or income-producing property in North Carolina including but not limited to . . . . . [t]rademarks [and] tradenames." Thus, Administrative Rule 17 NCAC 5C .0102 is deemed *prima facie* correct.

Upon administrative review of the Final Decision, the Board determines that the Assistant Secretary properly concluded the Taxpayers were "doing business" in this State and were therefore subject to this State's corporate income tax and corporate franchise tax. Applying the applicable statutes and administrative rule, the Assistant Secretary concluded that the Taxpayers were doing business in this State because they operate a business activity or enterprise in North Carolina for economic gain. In determining that the Taxpayers were doing business in North Carolina, the Assistant Secretary found that the Taxpayers own valuable intangible property in the form of trademarks, tradenames, and service marks and the goodwill associated with the marks. This property is business or income-producing property. The property is intangible property and, under applicable principles of law, has acquired a business situs where it is used. *See Wheeling Steel Corp. v. Fox*, 298 U.S. 193 (1936). The Taxpayers' property is used in North Carolina. Consequently, Taxpayers own business or income-producing property in North Carolina.

Applying the principles of trademark law, the Assistant Secretary ruled that Taxpayers' property cannot exist apart from an established business in which it is used; if the property is not used, the property is considered abandoned and ceases to exist. The Taxpayers' property therefore exists only where it is used. The Taxpayers' property

is used extensively in North Carolina in connection with established businesses. These established businesses are the 130 plus North Carolina retail locations of Taxpayers' related retail companies.

The record in this matter reflects that the Taxpayers' marks are permanently affixed to the retail locations and appear on the labels of merchandise sold at the locations. As a result, Taxpayers' marks are used at the retail locations each time employees at the locations sell merchandise. This use, which occurs in North Carolina, preserves the existence of Taxpayers' property.

The record also reflects that the Taxpayers rent their intangible property in North Carolina by licensing the use of the property to their related retail companies, which operate over 130 retail locations in North Carolina. The licensing agreements require the related companies to make royalty payments to Taxpayers for the use of Taxpayers' property. The Taxpayers purposefully license their property for use in this State. The Taxpayers in fact earn significant royalty income from the licensing agreements. The Taxpayers therefore license business or income producing property in North Carolina.

Based upon the facts, the Assistant Secretary concluded that the Taxpayers were doing business in North Carolina because they are operating a business enterprise or activity in North Carolina for economic gain. Thus, Taxpayers' activities fall within all three of the possible methods set out in Administrative Rule 17 NCAC 5C .0102(a)(5) by which an entity could be doing business in this State. The Taxpayers own business or income-producing property in North Carolina, the Taxpayers license business or income-producing property in North

Carolina, and the Taxpayers operate business or income-producing property in North Carolina. Thus, the Board determines that the record supports the Assistant Secretary's determination that the Taxpayers were "doing business" under the applicable North Carolina statutes and administrative rules and finds no merit in Taxpayers' argument that until the enactment of recent legislation, the statute did not authorize taxation of the Taxpayers.

The Board also determines that the Assistant Secretary properly concluded that the Taxpayers were "excluded corporations" within the meaning of G.S. 105-130.4(a)(4). G.S. 105-130.4(a)(4) defines an "excluded corporation" in pertinent part as "a corporation which receives more than fifty percent (50%) of its ordinary gross income from investments in and/or dealing in intangible property." The Assistant Secretary properly determined that the Taxpayers both "invest" and "deal" in the trademarks, which are intangible property. The Taxpayers received more than 50% of their ordinary gross income from their investments in or dealing in the trademarks. They therefore meet the statutory definition of "excluded corporation" set forth in G.S. 105-130.4(a)(4). Since the Taxpayers are "excluded corporations," G.S. 105-130.4(r) requires the Taxpayers to apportion their business income using the sales factor as determined under G.S. 105-130.4 (1).

Regarding Taxpayers' arguments that the Assistant Secretary's Final Decision should be reversed because physical presence in a state is a constitutional prerequisite for taxation; and since the Taxpayers are not physically present in North Carolina they cannot be taxed by North Carolina; the Tax Review Board, which is an administrative body, does not have the authority or jurisdiction to rule upon the constitutionality of a statute. *Great American*

Insurance Company v. Gold, 254, N. C. 168 (1961). Since these contentions involve constitutional issues, the Tax Review Board lacks authority or jurisdiction to address them. Thus, Taxpayers' constitutional claims are not issues that the Tax Review Board is empowered to determine.

The Board having conducted an administrative hearing in this matter, and having considered the petition, briefs, the whole record, the Assistant Secretary's final decision, the parties' arguments and the authorities cited, concludes that the findings of fact made by the Assistant Secretary in the final decision were fully supported by competent evidence in the record; that based upon the findings of fact, the Assistant Secretary's conclusions of law were fully supported by the findings of fact; therefore the final decision of the Secretary of Revenue should be confirmed.

In confirming the final decision in this matter, the Board takes administrative notice that the Assistant Secretary modified the proposed corporate franchise and income tax assessments for tax year 1994 by granting the Taxpayers' motion to waive the penalties imposed against them for tax year 1994. Although there is ample evidence in the record supporting the Department of Revenue's original imposition of penalties for tax year 1994, since the decision to waive penalties imposed by the Department of Revenue falls within the discretion of the Secretary of Revenue, this Board defers to the Secretary's determination.

WHEREFORE, THE TAX REVIEW BOARD ORDERS, ADJUDGES AND DECREES that the Final Decision entered by the Assistant Secretary in this matter

on September 19, 2000 be and is hereby **Confirmed** in its entirety.

Made and entered into the 7th day of May, 2002.

TAX REVIEW BOARD

[SEAL] Signature /s/ Richard H. Moore
Richard H. Moore, Chairman
State Treasurer

Signature /s/ Jo Anne Sanford
Jo Anne Sanford, Member
Chair, Utilities Commission

Signature /s/ Noel L. Allen
Noel L. Allen, Appointed Member

[Exhibit A – Listing of Evidence presented at the hearing before the Assistant Secretary of Revenue is intentionally omitted.]

APPENDIX D

STATE OF NORTH CAROLINA	BEFORE THE SECRETARY OF REVENUE
COUNTY OF WAKE	
IN THE MATTER OF:	
The Proposed Corporate Franchise and Income Tax Assessments for Fiscal Years ending January 31, 1992 through January 31, 1994 by the Secretary of Revenue of North Carolina	
vs.	**FINAL DECISION**
A&F Trademark, Inc., Caciqueco, Inc., Expressco, Inc., Lanco, Inc., Lernco, Inc., Limco Investments, Inc., Limtoo, Inc. Structureco, Inc. V. Secret Stores, Inc.	DOCKET NO. 97-990

An Administrative Hearing was conducted before Michael A. Hannah, Assistant Secretary of the North Carolina Department of Revenue, in the city of Raleigh on June 9 through June 11, 1998, regarding Notices of Tax Assessment proposed against A&F Trademark, Inc., Caciqueco, Inc., Expressco, Inc., Lanco, Inc., Lernco, Inc., Limco Investments, Inc., Limtoo, Inc., Structureco, Inc., and V. Secret Stores, Inc. ("Taxpayers"). The Taxpayers were represented by Paul H. Frankel, Hollis L. Hyans, and Craig B. Fields of Morrison & Foerster, LLP, and Jasper L.

Cummings, Jr., formerly of Alston & Bird, LLP. The Corporate, Excise, and Insurance Tax Division of the Department of Revenue was represented by Jack L. Harper, former Director, Donna P. Powell, Administrative Officer, and Kay Miller Hobart, Assistant Attorney General, North Carolina Attorney General's Office.

ISSUES

The issues to be decided in this matter are as follows:

I. Are the Taxpayers "doing business" in this State within the meaning of G.S. 105-130.3 and G.S. 105-114 so as to be subject to the corporate income and franchise tax?

II. Are the Taxpayers "excluded corporations" within the meaning of G.S. 105-130.4(a)(4)?

EVIDENCE

The following items were introduced by the parties at or subsequent to the hearing as exhibits and made part of the record:

Submitted by the Department:

D-1(a) Spreadsheet summary of corporate income tax, interest, penalty, and total assessments for tax years 1/31/92, 1/31/93, and 1/31/94 for A&F Trademark, Inc.; Caciqueco, Inc.; Expressco, Inc.; Lanco, Inc.; Lernco, Inc.; Limco Investments, Inc.; Limtoo, Inc.; Structureco Inc.; and V. Secret Stores, Inc.

D-1(b) Spreadsheet summary of franchise tax, interest, penalty, and total assessments for tax years 1/31/92, 1/31/93, and 1/31/94 for

A&F Trademark, Inc.; Caciqueco, Inc.; Expressco, Inc.; Lanco, Inc.; Lernco, Inc.; Limco Investments, Inc.; Limtoo, Inc.; Structureco Inc.; and V. Secret Stores, Inc.

D-1(c)(1) Notices of corporate income tax assessments, franchise tax assessments, field auditor's report, and audit worksheets for tax years 1/31/92, 1/31/93, and 1/31/94 for A&F Trademark, Inc.

D-1(c)(2) Notices of corporate income tax assessments, franchise tax assessments, field auditor's report, and audit worksheets for tax years 1/31/92, 1/31/93, and 1/31/94 for Caciqueco, Inc.

D-1(c)(3) Notices of corporate income tax assessments, franchise tax assessments, field auditor's report, and audit worksheets for tax years 1/31/92, 1/31/93, and 1/31/94 for Expressco, Inc.

D-1(c)(4) Notices of corporate income tax assessments, franchise tax assessments, field auditor's report, and audit worksheets for tax years 1/31/92, 1/31/93, and 1/31/94 for Lanco, Inc.

D-1(c)(5) Notices of corporate income tax assessments, franchise tax assessments, field auditor's report, and audit worksheets for tax years 1/31/92, 1/31/93, and 1/31/94 for Lernco, Inc.

D-1(c)(6) Notices of corporate income tax assessments, franchise tax assessments, field auditor's report, and audit worksheets for tax years 1/31/92, 1/31/93, and 1/31/94 for Limco Investments, Inc.

D-1(c)(7) Notices of corporate income tax assessments, franchise tax assessments, field auditor's report, and audit worksheets for tax years 1/31/92, 1/31/93, and 1/31/94 for Limtoo, Inc.

D-1(c)(8) Notices of corporate income tax assessments, franchise tax assessments, field auditor's report, and audit worksheets for tax years 1/31/92, 1/31/93, and 1/31/94 for Structureco, Inc.

D-1(c)(9) Notices of corporate income tax assessments, franchise tax assessments, field auditor's report, and audit worksheets for tax years 1/31/92, 1/31/93, and 1/31/94 for Victoria Secret Stores, Inc.

D-2(a) Correspondence dated April 22, 1996 to Department of Revenue from Morrison & Foerster protesting notices of tax assessment and requesting a consolidated tax hearing.

D-2(b) Correspondence dated September 15, 1997 to Jasper L. Cummings, Jr. from Michael A. Hannah, Assistant Secretary of Revenue, reserving the week of June 8, 1998 for an administrative tax hearing.

D-2(c) Correspondence dated April 14, 1998 to Jasper L. Cummings, Jr. from Michael A. Hannah, Assistant Secretary of Revenue, extending the dates for administrative hearing to include Friday, June 12, 1998.

D-3(a) Correspondence dated April 14, 1998 from Kay Miller Hobart, Assistant Attorney General, to Hollis Hyans of Morrison & Foerster

concerning stipulations to a test company case.

D-3(b) Draft stipulation of Express & Expressco as "test case" by Hollis Hyans of Morrison & Foerster dated March 26, 1998.

D-3(c) Correspondence dated April 30, 1998 from Hollis Hyans to Donna Powell, Administrative Officer at the Department, responding to Departmental request for information dated April 15, 1998.

D-4(a) Correspondence dated April 15, 1998 from Donna Powell, Administrative Officer, to Hollis Hyans of Morrison & Foerster requesting detailed factual information and other documents pertinent to facts and circumstances of protested issues.

D-4(b) Correspondence dated April 30, 1998 from Hollis Hyans of Morrison & Foerster to Donna Powell responding to Departmental request for information dated April 15, 1998.

D-4(c) Correspondence dated May 13, 1998 from Jack Harper, Director of the Department's Corporate, Excise, and Insurance Tax Division to Hollis Hyans of Morrison & Foerster requesting additional factual information pertinent to facts and circumstances of protested issues.

D-4(d) Correspondence dated June 6, 1998 from Jack Harper to Jasper L. Cummings, Jr. summarizing the information requested by the Department relative to the facts and circumstances of the protested issues not received as of June 6, 1998.

D-4(e)	Correspondence dated May 29, 1998 from Jasper L. Cummings, Jr. to Jack Harper advising Department of status of requested documents pertinent to facts and circumstances of protested issues.
D-4(f)	Correspondence dated June 5, 1998 from Jasper L. Cummings, Jr. to Donna Powell forwarding information requested pursuant to a review of federal consolidated 1120 tax returns in office of Jasper L. Cummings, Jr.
D-5	Graphic presentation of the chronology of transactions between the Limited Inc. and subsidiaries concerning the creation of affiliated corporations, and the transfer, sublicensing, or assignment of intangible assets.
D-6(a)	Initial Board of Directors' minutes of Limco Investments, Inc. dated January 29, 1981.
D-6(b)	Certificate of Incorporation from Delaware Secretary of State's Office for Limco Investments, Inc. dated December 19, 1980.
D-6(c)	Corporate Bylaws for Limco Investments, Inc.
D-7(a)	Assignment of trade/service marks from The Limited Stores, Inc. to Limco Investments, Inc. dated January 28, 1981.
D-7(b)	Legal name change document filed with the State of Delaware certifying that "Limco Investments, Inc." changed its name to "Limco, Inc." dated April 25, 1994.
D-8(a)	U.S. Patent Registration printout of record of trade/service mark "The Limited" owned by Limco, Inc.

D-8(b)	Portfolio printouts of Limco, Inc.'s "The Limited" trademarks in foreign jurisdictions.
D-9(a)	Related Company Agreement made and entered into February 1, 1981 between Limco Investments, Inc. and The Limited Stores, Inc.
D-9(b)	Amendment #1 to Related Company Agreement made and entered into June 29, 1981 between Limco Investments, Inc. and The Limited Stores, Inc.
D-9(c)	Amendment #3 to Related Company Agreement made and entered into October 22, 1987 between Limco Investments, Inc. and The Limited Stores, Inc.
D-9(d)	Amendment #4 to Related Company Agreement made and entered into May 1, 1989 between Limco Investments, Inc. and The Limited Stores, Inc.
D-9(e)	Amendment #5 to Related Company Agreement made and entered into September 15, 1992 between Limco Investments, Inc. and The Limited Stores, Inc.
D-10	Valuation study of tradename "The Limited" prepared by Arthur Consulting Group dated 1/29/94.
D-11(a)	License Agreement made and entered into September 10, 1987 by and between Limco, Investments, Inc. and Expressco, Inc.
D-11(b)	Sublease agreement made and entered into November 30, 1993 by and between Delaware Corporate Management, and Limco Investments, Inc.

D-11(c)	Board of Directors' minutes dated March 17, 1987 for Limco Investments, Inc.
D-12(a)	Board of Directors' minutes dated September 10, 1987 for Limco Investments, Inc.
D-12(b)	Board of Directors' minutes dated June 3, 1987 for Limco Investments, Inc.
D-13	Board of Directors' minutes dated December 1, 1987 for Limco Investments, Inc.
D-14	Board of Directors' minutes dated March 1, 1988 for Limco Investments, Inc.
D-15	Board of Directors' minutes dated June 15, 1988 for Limco Investments, Inc.
D-16	Board of Directors' minutes dated September 20, 1988 for Limco Investments, Inc.
D-17	Trade Property License Agreement between Limco Investments, Inc. and Aurora Resources, LP (unrelated third party) dated 8/24/88.
D-18(a)	Board of Directors' minutes dated March 12, 1991 for Limco Investments, Inc.
D-18(b)	Board of Directors' minutes dated December 6, 1988 for Limco Investments, Inc.
D-18(c)	Board of Directors' minutes dated June 4, 1991 for Limco Investments, Inc.
D-18(d)	Board of Directors' minutes dated September 9, 1991 for Limco Investments, Inc.
D-19	Board of Directors' minutes dated December 11, 1991 for Limco Investments, Inc.
D-20(a)	Board of Directors' minutes dated March 9, 1993 for Limco Investments, Inc.

D-20(b)	Board of Directors' minutes dated June 8, 1993 for Limco Investments, Inc.
D-20(c)	Board of Directors' minutes dated March 10, 1992 for Limco Investments, Inc.
D-20(d)	Board of Directors' minutes dated June 9, 1992 for Limco Investments, Inc.
D-20(e)	Board of Directors' minutes dated September 10, 1992 for Limco Investments, Inc.
D-20(f)	Board of Directors' minutes dated December 9, 1992 for Limco Investments, Inc.
D-21(a)	Board of Directors' minutes dated September 21, 1993 for Limco Investments, Inc.
D-21(b)	Board of Directors' minutes dated December 1, 1993 for Limco Investments, Inc.
D-22	Related Company Agreement made and entered between Expressco and The Limited Stores, Inc.
D-23(a)	License Agreement made and entered into March 31, 1989 between Limco Investments, Inc. and Expressco, Inc.
D-23(b)	Certificate of Incorporation from State of Delaware Secretary of State's Office for Expressco, Inc. dated September 9, 1987.
D-23(c)	State of Delaware 1992 annual franchise tax report for Expressco dated February 12, 1993.
D-23(d)	State of Delaware 1993 annual franchise tax report for Expressco dated February, 1994.
D-23(e)	State of Delaware 1994 annual franchise tax report for Expressco dated February 1, 1995.

D-23(f)	Corporate Bylaws for Expressco, Inc.
D-23(g)	Sublease Agreement dated November 30, 1993 between Delaware Corporate Management, Inc. and Expressco, Inc.
D-23(h)	Initial Board of Directors' minutes dated September 10, 1987 for Expressco, Inc.
D-24	Valuation study of trade/service mark "Campaigne Internationale Express" prepared by Price Waterhouse dated January 28, 1995.
D-25(a)	U.S. Patent Registration printout of record of trade/service mark "Exp and Design" owned by Expressco, Inc.
D-25(b)	Portfolio printouts of Expressco Inc.'s trademarks registered in foreign jurisdictions.
D-26	Board of Directors' minutes dated December 1, 1987 for Expressco, Inc.
D-27(a)	Board of Directors' minutes dated March 1, 1988 for Expressco, Inc.
D-27(b)	Board of Directors' minutes dated June 15, 1988 for Expressco, Inc.
D-27(c)	Board of Directors' minutes dated September 20, 1988 for Expressco, Inc.
D-27(d)	Board of Directors' minutes dated December 6, 1988 for Expressco, Inc.
D-27(e)	Board of Directors' minutes dated March 12, 1991 for Expressco, Inc.
D-27(f)	Board of Directors' minutes dated June 4, 1991 for Expressco, Inc.

D-27(g)	Board of Directors' minutes dated September 9, 1991 for Expressco, Inc.
D-27(h)	Board of Directors' minutes dated December 11, 1991 for Expressco, Inc.
D-28(a)	Board of Directors' minutes dated March 10, 1992 for Expressco, Inc.
D-28(b)	Board of Directors' minutes dated June 9, 1992 for Expressco, Inc.
D-28(c)	Board of Directors' minutes dated September 10, 1992 for Expressco, Inc.
D-28(d)	Board of Directors' minutes dated December 9, 1992 for Expressco, Inc.
D-29(a)	Board of Directors' minutes dated March 9, 1993 for Expressco, Inc.
D-29(b)	Board of Directors' minutes dated June 8, 1993 for Expressco, Inc.
D-29(c)	Board of Directors' minutes dated September 21, 1993 for Expressco, Inc.
D-29(d)	Board of Directors' minutes dated December 1, 1993 for Expressco, Inc.
D-30(a)	Initial Board minutes dated September 9, 1991 for Limtoo, Inc.
D-30(b)	Certificate of Incorporation from State of Delaware Secretary of State's Office for Limtoo, Inc. dated August 1, 1991.
D-30(c)	Bylaws of Limtoo, Inc.
D-31(a)	License Agreement made and entered into December 31, 1991 between Limco Investments, Inc. and Limtoo, Inc.

D-31(b)	Board of Directors' minutes dated December 11, 1991 for Limtoo, Inc.
D-32	Related Company Agreement between Limtoo, Inc. and Limited Too, Inc. dated September 9, 1991.
D-33	Copy of "Valuation of the Limited Too Tradename for Limtoo, Inc." prepared by Arthur Consulting Group dated July 1, 1992.
D-34(a)	Board of Directors' minutes dated March 9, 1993 for Limtoo, Inc.
D-34(b)	Board of Directors' minutes dated March 10, 1992 for Limtoo, Inc.
D-34(c)	Board of Directors' minutes dated June 9, 1992 for Limtoo, Inc.
D-34(d)	Board of Directors' minutes dated September 10, 1992 for Limtoo, Inc.
D-34(e)	Board of Directors' minutes dated December 9, 1992 for Limtoo, Inc.
D-34(f)	Board of Directors' minutes dated June 8, 1993 for Limtoo, Inc.
D-35(a)	Board of Directors' minutes dated September 21, 1993 for Limtoo, Inc.
D-35(b)	Board of Directors' minutes dated December 1, 1993 for Limtoo, Inc.
D-35(c)	Income Statement Analysis for Limtoo, Inc. for tax years ended 1992 through 1994.
D-35(d)	Balance Sheet and Statement of Income and Retained Earnings for Limtoo, Inc. for tax year ended 1992.

D-35(e)	Balance Sheet and Statement of Income and Retained Earnings for Limtoo, Inc. for tax year ended 1993.
D-35(f)	Balance Sheet and Statement of Income and Retained Earnings for Limtoo, Inc. for tax year ended 1994.
D-36	Board of Directors' minutes dated December 11, 1991 for Limtoo, Inc.
D-37(a)	U.S. Patent Registration printout of record of trade/service mark "STR" owned by Structureco, Inc.
D-37(b)	Portfolio printout of Structureco, Inc. trademark registered in foreign jurisdictions.
D-37(c)	Certificate of Incorporation from State of Delaware Secretary of State's Office for Structureco, Inc. dated August 1, 1991.
D-37(d)	Corporate Bylaws of Structureco, Inc.
D-38	Initial minutes of Board of Directors' meeting of Structureco, Inc. dated December 11, 1991.
D-39(a)	Related Company Agreement made and entered into December 11, 1991 by and between Structureco, Inc. and Express, Inc.
D-39(b)	Related Company Agreement made and entered into December 11, 1991 between Structureco, Inc. and Structure, Inc.
D-40	Valuation study of the tradename "Structure" prepared by Arthur Consulting Group, Inc.
D-41(a)	Board of Directors' minutes dated June 8, 1993 for Structureco, Inc.

D-41(b)	Board of Directors' minutes dated March 10, 1992 for Structureco, Inc.
D-41(c)	Board of Directors' minutes dated June 9, 1992 for Structureco, Inc.
D-41(d)	Board of Directors' minutes dated September 10, 1992 for Structureco, Inc.
D-41(e)	Board of Directors' minutes dated December 9, 1992 for Structureco, Inc.
D-41(f)	Board of Directors' minutes dated March 9, 1993 for Structureco, Inc.
D-42(a)	Board of Directors' minutes dated September 21, 1993 for Structureco, Inc.
D-42(b)	Board of Directors' minutes dated December 1, 1993 for Structureco, Inc.
D-42(c)	Income Statement Analysis of Structureco, Inc. for tax years ended 1992 through 1994.
D-42(d)	Balance Sheet and Statement of Income and Retained Earnings for Structureco, Inc. for tax year ended 1992.
D-42(e)	Balance Sheet and Statement of Income and Retained Earnings for Structureco, Inc. for tax year ended 1993.
D-42(f)	Balance Sheet and Statement of Income and Retained Earnings for Structureco, Inc. for tax year ended 1994.
D-43(a)	Initial Board of Directors' minutes dated September 9, 1991 for Caciqueco, Inc.
D-43(b)	Certificate of Incorporation from State of Delaware Secretary of State's Office for Caciqueco, Inc. dated August 1, 1991.

D-43(c)	Bylaws of Caciqueco, Inc.
D-44(a)	Assignment of Trademark "Cacique" from The Limited Stores, Inc. to Caciqueco, Inc. dated September 9, 1991.
D-44(b)	Related Company Agreement made and entered into as of January 1, 1991 by and between Caciqueco, Inc. and Cacique, Inc.
D-45(a)	U.S. Patent registration printout of record of tradename "Lingerie Cacique Care Essentials Design" owned by Caciqueco, Inc.
D-45(b)	Portfolio printout of Caciqueco, Inc. tradenames registered in foreign jurisdictions.
D-46	Related Company Agreement made and entered into January 1, 1992 by and between Caciqueco, Inc. and Cacique, Inc.
D-47	Valuation study of the tradename "Cacique" prepared by Arthur Consulting Group, Inc.
D-48(a)	Board of Directors' minutes dated December 11, 1991 for Caciqueco, Inc.
D-48(b)	Board of Directors' minutes dated March 10, 1992 for Caciqueco, Inc.
D-48(c)	Board of Directors' minutes dated June 9, 1992 for Caciqueco, Inc.
D-48(d)	Board of Directors' minutes dated September 10, 1992 for Caciqueco, Inc.
D-48(e)	Board of Directors' minutes dated December 9, 1992 for Caciqueco. Inc.
D-48(f)	Board of Directors' minutes dated March 9, 1993 for Caciqueco, Inc.

D-48(g)	Board of Directors' minutes dated June 8, 1993 for Caciqueco, Inc.
D-49(a)	Board of Directors' minutes dated September 21, 1993 for Caciqueco, Inc.
D-49(b)	Board of Directors' minutes dated December 1, 1993 for Caciqueco, Inc.
D-49(c)	Income Statement Analysis of Caciqueco, Inc. for tax years ended 1992 through 1994.
D-49(d)	Balance Sheet and Statement of Income and Retained Earnings for Caciqueco, Inc. for tax year ended 1992.
D-49(e)	Balance Sheet and Statement of Income and Retained Earnings for Caciqueco, Inc. for tax year ended 1993.
D-49(f)	Balance Sheet and Statement of Income and Retained Earnings for Caciqueco, Inc. for tax year ended 1994.
D-50(a)	Assignment of trademark "Victoria's Secret" from Victoria's Secret, Inc. to V. Secret, Inc. dated January 26, 1987.
D-50(b)	Certificate of Incorporation from State of Delaware Secretary of State's Office for V. Secret, Inc. dated November 2, 1983.
D-50(c)	Certificate of Incorporation from State of Delaware Secretary of State's Office for V. Secret Stores, Inc. dated December 1, 1988.
D-50(d)	Certificate of Incorporation from State of Delaware Secretary of State's Office for Victoria's Secret, Inc. dated January 9, 1989.

D-51(a)	Related Company Agreement made and entered into January 1, 1987 between V. Secrets, Inc. and Victoria's Secret Inc.
D-51(b)	Related Company Agreement made and entered into January 1, 1989 between V. Secret Stores, Inc. and Victoria's Secret, Inc.
D-52(a)	License Agreement made and entered into January 1, 1989 between V. Secret, Inc. and V. Secret Stores, Inc.
D-52(b)	Board of Directors' minutes dated March 17, 1987 for V. Secret, Inc.
D-52(c)	Board of Directors' minutes dated June 3, 1987 for V. Secret, Inc.
D-52(d)	Board of Directors' minutes dated September 10, 1987 for V. Secret, Inc.
D-52(e)	Board of Directors' minutes dated December 1, 1987 for V. Secret, Inc.
D-52(f)	Board of Directors' minutes dated March 1, 1988 for V. Secret, Inc.
D-52(g)	Board of Directors' minutes dated June 15, 1988 for V. Secret, Inc.
D-52(h)	Board of Directors' minutes dated September 20, 1988 for V. Secret, Inc.
D-52(i)	Board of Directors' minutes dated March 12, 1991 for V. Secret Stores, Inc.
D-52(j)	Board of Directors' minutes dated June 4, 1991 for V. Secret Stores, Inc.
D-52(k)	Board of Directors' minutes dated September 9, 1991 for V. Secret Stores, Inc.

D-52(l)	Board of Directors' minutes dated December 11, 1991 for V. Secret Stores, Inc.
D-52(m)	Board of Directors' minutes dated March 10, 1992 for V. Secret Stores, Inc.
D-52(n)	Board of Directors' minutes dated June 9, 1992 for V. Secret Stores, Inc.
D-52(o)	Board of Directors' minutes dated September 10, 1992 for V. Secret Stores, Inc.
D-52(p)	Board of Directors' minutes dated December 9, 1992 for V. Secret Stores Inc.
D-52(q)	Board of Directors' minutes dated March 9, 1993 for V. Secret Stores, Inc.
D-52(r)	Board of Directors' minutes dated June 8, 1993 for V. Secret Stores, Inc.
D-52(s)	Board of Directors' minutes dated September 21, 1993 for V. Secret Stores, Inc.
D-52(t)	Board of Directors' minutes dated December 1, 1993 for V. Secret Stores, Inc.
D-52(u)	Income Statement Analysis of V. Secret Stores, Inc. for tax years ended 1992 through 1994.
D-52(v)	Balance Sheet and Statement of Income and Retained Earnings for V. Secret Stores, Inc. for tax year ended 1992.
D-52(w)	Balance Sheet and Statement of Income and Retained Earnings for V. Secret Stores, Inc. for tax year ended 1993.
D-52(x)	Balance Sheet and Statement of Income and Retained Earnings for V. Secret Stores, Inc. for tax year ended 1994.

D-52(y)	"Subscription to Shares" of V. Secret Stores, Inc. dated December 1, 1988.
D-52(z)	Sublease Agreement made and entered into November 30, 1993 by and between Delaware Corporate Management, Inc. and V. Secret Catalogue, Inc.
D-53	Trade Property License Agreement between V. Secret, Inc. and Aurora Resources, LP dated August 24, 1988.
D-54	Valuation Study of tradename "Victoria's Secret" as compiled by Price Waterhouse, LLP dated May 24, 1995.
D-55(a)	U.S. Patent Registration printout of record of trade/service mark "LB for Short" owned by Lanco, Inc.
D-55(b)	Portfolio printouts of Lanco, Inc.'s "Lane Byrant [sic]" trademarks in foreign jurisdictions.
D-56(a)	Assignment of trade/service marks "Lane Bryant," "Smart Size," "LB," "LB for Short," and "Nancy's Choice" from Lane Bryant, Inc. to Lanco, Inc.
D-56(b)	Certificate of Incorporation from State of Delaware Secretary of State's Office for Lanco, Inc. dated December 15, 1982.
D-56(c)	Bylaws of Lanco, Inc.
D-56(d)	Sublease Agreement made and entered into November 30, 1993 between Delaware Corporate Management, Inc. and Lanco, Inc.
D-57(a)	Related Company Agreement made and entered into February 2, 1986 between Lanco, Inc. and Lane Bryant, Inc.

D-57(b)	Board of Directors' minutes dated March 17, 1987 for Lanco, Inc.
D-57(c)	Board of Directors' minutes dated September 10, 1987 for Lanco, Inc.
D-57(d)	Board of Directors' minutes dated June 3, 1987 for Lanco, Inc.
D-57(e)	Board of Directors' minutes dated December 1, 1987 for Lanco, Inc.
D-57(f)	Board of Directors' minutes dated March 1, 1988 for Lanco, Inc.
D-57(g)	Board of Directors' minutes dated June 15, [1988] for Lanco, Inc.
D-57(h)	Board of Director's minutes dated September 20, 1988 for Lanco, Inc.
D-57(i)	Board of Directors' minutes dated December 6, 1988 for Lanco, Inc.
D-57(j)	Board of Directors' minutes dated March 10, 1992 for Lanco, Inc.
D-57(k)	Board of Directors' minutes dated June 9, 1992 for Lanco, Inc.
D-57(l)	Board of Directors' minutes dated September 10, 1992 for Lanco, Inc.
D-57(m)	Board of Directors' minutes dated December 9, 1992 for Lanco, Inc.
D-57(n)	Board of Directors' minutes dated March 12, 1991 for Lanco, Inc.
D-57(o)	Board of Directors' minutes dated June 4, 1991 for Lanco, Inc.

D-58(a)	Board of Directors' minutes dated March 10, 1992 for Lanco, Inc.
D-58(b)	Board of Directors' minutes dated June 9, 1992 for Lanco, Inc.
D-58(c)	Board of Directors' minutes dated September 10, 1992 for Lanco, Inc.
D-58(d)	Board of Directors' minutes dated December 9, 1992 for Lanco, Inc.
D-58(e)	Board of Directors' minutes dated March 9, 1993 for Lanco, Inc.
D-58(f)	Board of Directors' minutes dated June 8, 1993 for Lanco, Inc.
D-58(g)	Board of Directors' minutes dated September 21, 1993 for Lanco, Inc.
D-58(h)	Board of Directors' minutes dated December 1, 1993 for Lanco, Inc.
D-59	Valuation study of trade/service mark "Lane Bryant" as compiled by Price Waterhouse, LLP dated January 28, 1995.
D-60(a)	Assignment of trade/service mark "Lerner" from Associated Lerner Shops of America, Inc. to Lerner, Inc. dated June 6, 1985.
D-60(b)	Certificate of Incorporation from State of Delaware Secretary of State's Office for Lernco, Inc. dated May 2, 1985.
D-60(c)	Corporate Bylaws for Lernco.
D-60(d)	Sublease Agreement made and entered into January 9, 1989 between Delaware Corporate Management and Lernco, Inc.

D-61(a)	U.S. Patent Registration printout of record of trade/service mark "Lerner" owned by Lernco, Inc.
D-61(b)	Portfolio printouts of Lernco, Inc.'s "Lerner" trademarks in foreign jurisdictions.
D-62(a)	Related Company Agreement made and entered into June 6, 1985 between Lernco, Inc. and Lerner Stores, Inc.
D-62(b)	Board of Directors' minutes dated March 12, 1991 for Lernco, Inc.
D-62(c)	Board of Directors' minutes dated June 4, 1991 for Lernco, Inc.
D-62(d)	Board of Directors' minutes dated September 9, 1991 for Lernco, Inc.
D-62(e)	Board of Directors' minutes dated December 11, 1991 for Lernco, Inc.
D-62(f)	Board of Directors' minutes dated March 10, 1992 for Lernco, Inc.
D-62(g)	Board of Directors' minutes dated June 9, 1992 for Lernco, Inc.
D-62(h)	Board of Directors' minutes dated September 10, 1992 for Lernco, Inc.
D-62(i)	Board of Directors' minutes dated December 9, 1992 for Lernco, Inc.
D-63(a)	Board of Directors' minutes dated March 9, 1993 for Lernco, Inc.
D-63(b)	Board of Directors' minutes dated June 8, 1993 for Lernco, Inc.
D-63(c)	Board of Directors' minutes dated September 21, 1993 for Lernco, Inc.

D-63(d)	Board of Directors' minutes dated December 1, 1993 Lernco, Inc.
D-63(e)	Income Statement Analysis of Lernco, Inc. for tax years ended 1992-1994.
D-63(f)	Balance Sheet and Statement of Income and Retained Earnings for Lernco, Inc. for tax year ended 1992.
D-63(g)	Balance Sheet and Statement of Income and Retained Earnings for Lernco, Inc. for tax year ended 1993.
D-63(h)	Balance Sheet and Statement of Income and Retained Earnings for Lernco, Inc. for tax year ended 1994.
D-64	Valuation study of trade/service marks Lerner as compiled by Price Waterhouse, LLP dated October 31, 1989.
D-65(a)	U.S. Patent Registration printout of record of trade/service mark "Abercrombie & Fitch" owned by A&F Trademark, Inc.
D-65(b)	Portfolio printouts of A&F Trademark, Inc.'s "Abercrombie & Fitch" trademark in foreign jurisdictions.
D-66(a)	Related Company Agreement made and entered into February 2, 1988 between A&F Trademark, Inc. and Abercrombie & Fitch, Inc.
D-66(b)	Certificate of Incorporation from State of Delaware Secretary of State's Office for A&F Trademark, Inc. dated February 2, 1988.
D-66(c)	Corporate Bylaws for A&F Trademark, Inc.

D-66(d)	Board of Directors' minutes dated March 12, 1991 for A&F Trademark, Inc.
D-66(e)	Board of Directors' minutes dated June 4, 1991 for A&F Trademark, Inc.
D-66(f)	Board of Directors' minutes dated September 9, 1991 for A&F Trademark, Inc.
D-66(g)	Board of Directors' minutes dated December 11, 1991 for A&F Trademark, Inc.
D-66(h)	Board of Directors' minutes dated March 10, 1992 for A&F Trademark, Inc.
D-66(i)	Board of Directors' minutes dated June 9, 1992 for A&F Trademark. Inc.
D-66(j)	Board of Directors' minutes dated September 10, 1992 for A&F Trademark, Inc.
D-66(k)	Board of Directors' minutes dated December 9, 1992 for A&F Trademark, Inc.
D-66(l)	Board of Directors' minutes dated March 9, 1993 for A&F Trademark, Inc.
D-66(m)	Board of Directors' minutes dated June 8, 1993 for A&F Trademark, Inc.
D-67	Board of Directors' minutes dated September 21, 1993 for A&F Trademark, Inc.
D-68	Graphic of the Limited, Inc. and its subsidiaries displaying the licensing relationship between the retail operation and trademark entity.
D-69(a)	Letter outlining services provided to Delaware Holding Companies from Gunnip & Company, a nexus service provider, dated January 5, 1987.

D-69(b)	Printout of corporations listing "1105 North Market Street, Wilmington, Delaware" as their principal physical address.
D-69(c)	Resolution authorizing Wilmington Trust to act as a depository of funds for Limtoo, Inc. dated September 9, 1991.
D-69(d)	Invoice from Delaware Corporate Management to Limco Investments, Inc. dated January 19, 1993 for accounting services.
D-70	Summary of Trademark Companies' Royalty and Interest Income for tax years ended 1992 through 1994.
D-71	Graphic displaying "Circular Flow of Transactions" between retail companies and their related trademark companies.
D-72	Analysis of gross income and expenses of trademark companies and their related retail companies.
D-73(a)	"Analysis of accrued royalties" for Expressco, Inc. for taxable years ended 1992, 1993, and 1994.
D-73(b)	Balance Sheet for Expressco, Inc. for taxable years ended 1992, 1993, and 1994.
D-73(c)	Wilmington Trust Statement of Account for Expressco, Inc. for taxable years ended January 31, 1992, January 29, 1993, and January 31, 1994.
D-73(d)	Wilmington Trust Bank Statement for Expressco, Inc. dated April 3, 1992.
D-73(e)	Note between Express, Inc. and Expressco, Inc. dated September 20, 1992.

D-73(f)	"Analysis of accrued royalties" for Limco Investments, Inc. for taxable years ended 1992, 1993, and 1994.
D-73(g)(1)	Balance Sheets for Limco Investments, Inc. for taxable year ended 1992.
D-73(g)(2)	Balance Sheets for Limco Investments, Inc. for taxable year ended 1994.
D-73(h)(1)	Wilmington Trust Statements of Account for Limco Investments, Inc. for taxable year ended 1992.
D-73(h)(2)	Wilmington Trust Statements of Account for Limco Investments, Inc. for taxable year ended 1993.
D-73(h)(3)	Wilmington Trust Statements of Account for Limco Investments, Inc. for taxable year ended 1994.
D-73(i)(1)	Wilmington Trust Bank Statements for Limco Investments, Inc. dated April 3, 1992.
D-73(i)(2)	Wilmington Trust Bank Statements for Limco Investments, Inc. dated January 29, 1993.
D-73(j)	Note between the Limited Stores, Inc. and Limco, Inc. dated September 20, 1992.
D-73(k)	"Analysis of accrued royalties" for V. Secret Stores, Inc. for taxable year ended 1992, 1993, and 1994.
D-73(l)(1)	Balance Sheets for V. Secret Stores, Inc. for taxable year ended February 1, 1992.
D-73(l)(2)	Balance Sheets for V. Secret Stores, Inc. for taxable year ended January 30, 1993.

D-73(l)(3)	Balance Sheets for V. Secret Stores, Inc. for taxable year ended January 29, 1994.
D-73(m)(1)	Statements of Income and Retained Earnings for V. Secret Stores, Inc. for taxable year ended February 1, 1992.
D-73(m)(2)	Statements of Income and Retained Earnings for V. Secret Stores, Inc. for taxable year ended January 30, 1993.
D-73(m)(3)	Statements of Income and Retained Earnings for V. Secret Stores, Inc. for taxable year ended January 29, 1994.
D-73(n)(1)	Wilmington Trust Statements of Account for V. Secret Stores, Inc. for taxable year ended January 31, 1992.
D-73(n)(2)	Wilmington Trust Statements of Account for V. Secret Stores, Inc. for taxable year ended January 29, 1993.
D-73(n)(3)	Wilmington Trust Statements of Account for V. Secret Stores, Inc. for taxable year ended January 28, 1994.
D-73(o)(1)	Wilmington Trust Bank Statements for V. Secret Stores, Inc. dated April 3, 1992.
D-73(o)(2)	Wilmington Trust Bank Statements for V. Secret Stores, Inc. dated January 28, 1994.
D-73(p)(1)	Notes between Victoria's Secret Stores, Inc. and V. Secret Stores, Inc. dated September 20, 1992.
D-73(p)(2)	Notes between Victoria's Secret Stores, Inc. and V. Secret Stores, Inc. dated November 9, 1992.

D-74(a)	Note between Express, Inc. and Expressco, Inc. dated November 9, 1992.
D-74(b)	Note between Victoria's Secret Stores, Inc. and V. Secret Stores, Inc. dated February 7, 1992.
D-74(c)	Note between Abercrombie & Fitch, Inc. and A&F Trademark, Inc. dated November 9, 1992.
D-74(d)	Note between Victoria's Secret Stores, Inc. and V. Secret Stores, Inc. dated August 10, 1992.
D-74(e)	Note between Victoria's Secret Stores, Inc. and V. Secret Stores, Inc. dated May 12, 1992.
D-74(f)	Note between Lane Bryant, Inc. and Lanco, Inc. dated March 20, 1989.
D-74(g)	Note between Lane Bryant, Inc. and Lanco, Inc. dated September 20, 1990.
D-74(h)	Note between Abercrombie & Fitch, Inc. and A&F Trademark, Inc. dated September 20, 1992.
D-74(i)	Note between Abercrombie & Fitch, Inc. and A&F Trademark, Inc. dated May 12, 1992.
D-74(j)	Note between Lane Bryant, Inc. and Lanco, Inc. dated September 20, 1992.
D-74(k)	Note between Lerner Stores, Inc. and Lernco, Inc. dated September 20, 1992.
D-74(l)	Note between Lane Bryant, Inc. and Lanco, Inc. dated September 20, 1989.

D-74(m)	Note between Lane Bryant, Inc. and Lanco, Inc. dated September 20, 1991.
D-74(n)	Note between Lane Bryant, Inc. and Lanco, Inc. dated September 20, 1992.
D-74(o)	Note between Lane Bryant, Inc. and Lanco, Inc. dated March 20, 1993.
D-74(p)	Note between Lane Bryant, Inc. and Lanco, Inc. dated September 20, 1992.
D-74(q)	Note between Lane Bryant, Inc. and Lanco, Inc. dated March 20, 1993.
D-74(r)	Note between Lane Bryant, Inc. and Lanco, Inc. dated September 20, 1993.
D-74(s)	Note between Lane Bryant, Inc. and Lanco, Inc. dated March 20, 1991.
D-75(a)	Related Company Agreement Amendment # 3 made and entered into October 22, 1987 between Limco, Investments, Inc. and The Limited Stores, Inc.
D-75(b)	Related Company Agreement made and entered into February 1, 1981 between Limco Investments, Inc. and The Limited Stores, Inc.
D-75(c)	Related Company Agreement Amendment # 1 made and entered into June 29, 1981 between Limco Investments, Inc. and The Limited Stores. Inc.
D-75(d)	Related Company Agreement Amendment # 2 made and entered into September 10, 1987 between Limco Investments, Inc. and The Limited Stores, Inc.

D-75(e)	Related Company Agreement Amendment #4 made and entered into May 1, 1989 between Limco Investments, Inc. and The Limited Stores, Inc.
D-75(f)	Related Company Agreement Amendment #5 made and entered into September 15, 1992 between Limco Investments, Inc. and The Limited Stores, Inc.
D-75(g)	Related Company Agreement Amendment #2 made and entered into May 1, 1989 between Lanco, Inc. and Lane Bryant, Inc.
D-75(h)	Related Company Agreement made and entered into February 2, 1986 between Lanco, Inc. and Lane Bryant, Inc.
D-75(i)	Related Company Agreement Amendment #1 made and entered into October 22, 1987 between Lanco, Inc. and Lane Bryant, Inc.
D-75(j)	Related Company Agreement Amendment #1 made and entered into May 1, 1989 between V. Secret, Inc. and Victoria's Secret Catalogue, Inc.
D-75(k)	Related Company Agreement Amendment # 2 made and entered into May 1, 1989 between Lernco, Inc. and Lerner Stores, Inc.
D-76(a)	Securities and Exchange Commission 10-K Reports for the Limited and subsidiaries dated February 2, 1991.
D-76(b)	Securities and Exchange Commission 10-K Reports for the Limited and subsidiaries dated February 2, 1992.

D-76(c)	Securities and Exchange Commission 10-K Reports for the Limited and subsidiaries dated January 30, 1993.
D-76(d)	Securities and Exchange Commission 10-K Reports for the Limited and subsidiaries dated January 29, 1994.
D-77	North Carolina Administrative Rule 17 NCAC 5C.0102, "Doing Business Defined".
D-78	Omitted.
D-79	North Carolina Department of Revenue Redacted Final Decision Docket Number 90-33.
D-80	Excerpt from "State Taxation – 1997/1998 Cumulative Supplement" by Jerome R. Hellerstein and Walter Hellerstein.
D-81(a)	Colucci & Umans' legal fee billing statement for Limco Investments, Inc. dated December 31, 1992.
D-81(b)	Wilmington Trust Bank Statement for Limco Investments, Inc. dated April 2, 1993.
D-81(c)	Colucci & Umans' legal fee billing for Expressco, Inc. dated November 30, 1992.
D-81(d)	Wilmington Trust Bank Statement for Expressco, Inc. dated April 2, 1993.
D-81(e)	Colucci & Umans' legal fee billing for V. Secret Stores, Inc. dated December 31, 1992.
D-81(f)	Wilmington Trust Bank Statement for V. Secret Stores, Inc. dated April 2, 1993.
D-81(g)	Colucci & Umans' legal fee billing for Limco Investments, Inc. dated December 31, 1992.

D-81(h)	Wilmington Trust Bank Statement for Limco Investments, Inc. dated April 2, 1993.
D-81(i)	Colucci & Umans' legal fee billing for Limco Investments, Inc. dated September 30, 1992.
D-81(j)	Wilmington Trust Bank Statement for Limco Investments, Inc. dated February 26, 1993.
D-81(k)	Colucci & Umans' legal fee billing for Expressco, Inc. dated November 30, 1992.
D-81(l)	Wilmington Trust Bank Statement for Expressco, Inc. dated April 2, 1993.
D-81(m)	Colucci & Umans' legal fee billing for Expressco, Inc. dated December 31, 1992.
D-81(n)	Wilmington Trust Bank Statement for Expressco, Inc. dated May 28, 1993.
D-82(a)(1)	January 1992 Balance Sheet for A&F Trademark, Inc.
D-82(a)(2)	January 1992 Balance Sheet for Caciqueco, Inc.
D-82(a)(3)	January 1992 Balance Sheet for Expressco, Inc.
D-82(a)(4)	January 1992 Balance Sheet for Lanco Inc.
D-82(a)(5)	January 1992 Balance Sheet for Lernco, Inc.
D-82(a)(6)	January 1992 Balance Sheet for Limco Investments, Inc.
D-82(a)(7)	January 1992 Balance Sheet for Limtoo, Inc.
D-82(a)(8)	January 1992 Balance Sheet for Structureco, Inc.

D-82(a)(9)	January 1992 Balance Sheet for V. Secret Stores, Inc.
D-82(b)(1)	January 1993 Balance Sheet for A&F Trademark, Inc.
D-82(b)(2)	January 1993 Balance Sheet for Caciqueco, Inc.
D-82(b)(3)	January 1993 Balance Sheet for Expressco, Inc.
D-82(b)(4)	January 1993 Balance Sheet for, Lanco Inc.
D-82(b)(5)	January 1993 Balance Sheet for Lernco, Inc.
D-82(b)(6)	January 1993 Balance Sheet for Limco Investments, Inc.
D-82(b)(7)	January 1993 Balance Sheet for Limtoo, Inc.
D-82(b)(8)	January 1993 Balance Sheet for Structureco, Inc.
D-82(b)(9)	January 1993 Balance Sheet for V. Secret Stores, Inc.
D-82(c)(1)	January 1994 Balance Sheet for A&F Trademark, Inc.
D-82(c)(2)	January 1994 Balance Sheet for Caciqueco, Inc.
D-82(c)(3)	January 1994 Balance Sheet for Expressco, Inc.
D-82(c)(4)	January 1994 Balance Sheet for Lanco Inc.
D-82(c)(5)	January 1994 Balance Sheet for Lernco, Inc.
D-82(c)(6)	January 1994 Balance Sheet for Limco Investments, Inc.
D-82(c)(7)	January 1994 Balance Sheet for Limtoo, Inc.

D-82(c)(8)	January 1994 Balance Sheet for Structureco, Inc.
D-82(c)(9)	January 1994 Balance Sheet for V. Secret Stores, Inc.
D-82(d)(1)	January 1992 Statement of Income and Retained Earnings for A&F Trademark, Inc.
D-82(d)(2)	January 1992 Statement of Income and Retained Earnings for Caciqueco, Inc.
D-82(d)(3)	January 1992 Statement of Income and Retained Earnings for Expressco, Inc.
D-82(d)(4)	January 1992 Statement of Income and Retained Earnings for Lanco, Inc.
D-82(d)(5)	January 1992 Statement of Income and Retained Earnings for Lernco, Inc.
D-82(d)(6)	January 1992 Statement of Income and Retained Earnings for Limco Investments, Inc.
D-82(d)(7)	January 1992 Statement of Income and Retained Earnings for Limtoo, Inc.
D-82(d)(8)	January 1992 Statement of Income and Retained Earnings for Structureco, Inc.
D-82(d)(9)	January 1992 Statement of Income and Retained Earnings for V. Secret Stores, Inc.
D-82(e)(1)	January 1993 Statement of Income and Retained Earnings for A&F Trademark, Inc.
D-82(e)(2)	January 1993 Statement of Income and Retained Earnings for Caciqueco, Inc.
D-82(e)(3)	January 1993 Statement of Income and Retained Earnings for Expressco, Inc.

D-82(e)(4)	January 1993 Statement of Income and Retained Earnings for Lanco, Inc.
D-82(e)(5)	January 1993 Statement of Income and Retained Earnings for Lernco, Inc.
D-82(e)(6)	January 1993 Statement of Income and Retained Earnings for Limco Investments, Inc.
D-82(e)(7)	January 1993 Statement of Income and Retained Earnings for Limtoo, Inc.
D-82(e)(8)	January 1993 Statement of Income and Retained Earnings for Structureco, Inc.
D-82(e)(9)	January 1994 Statement of Income and Retained Earnings for V. Secret Stores, Inc.
D-82(f)(1)	January 1994 Statement of Income and Retained Earnings for A&F Trademark, Inc.
D-82(f)(2)	January 1994 Statement of Income and Retained Earnings for Caciqueco, Inc.
D-82(f)(3)	January 1994 Statement of Income and Retained Earnings for Expressco, Inc.
D-82(f)(4)	January 1994 Statement of Income and Retained Earnings for Lanco, Inc.
D-82(f)(5)	January 1994 Statement of Income and Retained Earnings for Lernco, Inc.
D-82(f)(6)	January 1994 Statement of Income and Retained Earnings for Limco Investments, Inc.
D-82(f)(7)	January 1994 Statement of Income and Retained Earnings for Limtoo, Inc.
D-82(f)(8)	January 1994 Statement of Income and Retained Earnings for Structureco, Inc.

D-82(f)(9)	January 1994 Statement of Income and Retained Earnings for V. Secret Stores, Inc.
D-83(a)(1)	January 30, 1992 pro-forma federal tax returns for A&F Trademark, Inc.
D-83(a)(2)	January 30, 1992 pro-forma federal tax returns for Caciqueco, Inc.
D-83(a)(3)	January 30, 1992 pro-forma federal tax returns for Expressco, Inc.
D-83(a)(4)	January 30, 1992 pro-forma federal tax returns for Lanco, Inc.
D-83(a)(5)	January 30, 1992 pro-forma federal tax returns for Lernco, Inc.
D-83(a)(6)	January 30, 1992 pro-forma federal tax returns for Limco Investments, Inc.
D-83(a)(7)	January 30, 1992 pro-forma federal tax returns for Limtoo, Inc.
D-83(a)(8)	January 30, 1992 pro-forma federal tax returns for Structureco, Inc.
D-83(a)(9)	January 30, 1992 pro-forma federal tax returns for V. Secret Stores, Inc.
D-83(a)(10)	January 30, 1992 pro-forma federal tax returns for Abercrombie & Fitch, Inc.
D-83(a)(11)	January 30, 1992 pro-forma federal tax returns for Cacique, Inc.
D-83(a)(12)	January 30, 1992 pro-forma federal tax returns for Express, Inc.
D-83(a)(13)	January 30, 1992 pro-forma federal tax returns for Lane Bryant, Inc.

D-83(a)(14)	January 30, 1992 pro-forma federal tax returns for Lerner New York, Inc.
D-83(a)(15)	January 30, 1992 pro-forma federal tax returns for Limited Stores, Inc.
D-83(a)(16)	January 30, 1992 pro-forma federal tax returns for Limited Too, Inc.
D-83(a)(17)	January 30, 1992 pro-forma federal tax returns for Structure, Inc.
D-83(a)(18)	January 30, 1992 pro-forma federal tax returns for Victoria's Secret Stores, Inc.
D-83(a)(19)	Federal Corporation Income Tax Return (Consolidated Federal 1120) for The Limited, Inc. and Subsidiaries, for tax year ended 1992.
D-83(b)(1)	January 30, 1993 pro-forma federal tax returns for A&F Trademark, Inc.
D-83(b)(2)	January 30, 1993 pro-forma federal tax returns for Caciqueco, Inc.
D-83(b)(3)	January 30, 1993 pro-forma federal tax returns for Expressco, Inc.
D-83(b)(4)	January 30, 1993 pro-forma federal tax returns for Lanco, Inc.
D-83(b)(5)	January 30, 1993 pro-forma federal tax returns for Lernco, Inc.
D-83(b)(6)	January 30, 1993 pro-forma federal tax returns for Limco Investments, Inc.
D-83(b)(7)	January 30, 1993 pro-forma federal tax returns for Limtoo, Inc.
D-83(b)(8)	January 30, 1993 pro-forma federal tax returns for Structureco, Inc.

D-83(b)(9)	January 30, 1993 pro-forma federal tax returns for V. Secret Stores, Inc.
D-83(b)(10)	January 30, 1993 pro-forma federal tax returns for Abercrombie & Fitch, Inc.
D-83(b)(11)	January 30, 1993 pro-forma federal tax returns for Cacique, Inc.
D-83(b)(12)	January 30, 1993 pro-forma federal tax returns for Express, Inc.
D-83(b)(13)	January 30, 1993 pro-forma federal tax returns for Lane Bryant, Inc.
D-83(b)(14)	January 30, 1993 pro-forma federal tax returns for Lerner New York, Inc.
D-83(b)(15)	January 30, 1993 pro-forma federal tax returns for Limited Stores, Inc.
D-83(b)(16)	January 30, 1993 pro-forma federal tax returns for Limited Too, Inc.
D-83(b)(17)	January 30, 1993 pro-forma federal tax returns for Structure, Inc.
D-83(b)(18)	January 30, 1993 pro-forma federal tax returns for Victoria's Secret Stores, Inc.
D-83(b)(19)	Federal Corporation Income Tax Return (Consolidated Federal 1120) for The Limited, Inc. and Subsidiaries, 31-1029810, for tax year ended 1993.
D-83(c)(1)	January 30, 1994 pro-forma federal tax returns for A&F Trademark, Inc.
D-83(c)(2)	January 30, 1994 pro-forma federal tax returns for Caciqueco, Inc.
D-83(c)(3)	January 30, 1994 pro-forma federal tax returns for Expressco, Inc.

D-83(c)(4)	January 30, 1994 pro-forma federal tax returns for Lanco, Inc.
D-83(c)(5)	January 30, 1994 pro-forma federal tax returns for Lernco, Inc.
D-83(c)(6)	January 30, 1994 pro-forma federal tax returns for Limco Investments, Inc.
D-83(c)(7)	January 30, 1994 pro-forma federal tax returns for Limtoo, Inc.
D-83(c)(8)	January 30, 1994 pro-forma federal tax returns for Structureco, Inc.
D-83(c)(9)	January 30, 1994 pro-forma federal tax returns for V. Secret Stores, Inc.
D-83(c)(10)	January 30, 1994 pro-forma federal tax returns for Abercrombie & Fitch, Inc.
D-83(c)(11)	January 30, 1994 pro-forma federal tax returns for Cacique, Inc.
D-83(c)(12)	January 30, 1994 pro-forma federal tax returns for Express, Inc.
D-83(c)(13)	January 30, 1994 pro-forma federal tax returns for Lane Bryant, Inc.
D-83(c)(14)	January 30, 1994 pro-forma federal tax returns for Lerner New York, Inc.
D-83(c)(15)	January 30, 1994 pro-forma federal tax returns for Limited Stores, Inc.
D-83(c)(16)	January 30, 1994 pro-forma federal tax returns for Limited Too, Inc.
D-83(c)(17)	January 30, 1994 pro-forma federal tax returns for Structure, Inc.

D-83(c)(18)	January 30, 1994 pro-forma federal tax returns for Victoria's Secret Stores, Inc.
D-83(c)(19)	Federal Corporation Income Tax Return (Consolidated Federal 1120) for The Limited, Inc. and Subsidiaries, 31-1029810, for tax year ended 1994.
D-84(a)	1991 Annual Report for The Limited, Inc.
D-84(b)	1992 Annual Report for The Limited, Inc.
D-84(c)	1993 Annual Report for The Limited, Inc.
D-85	Transcript of Administrative Tax Hearing held June 9, 1998 through June 12, 1998 regarding the proposed assessments against: A&F Trademark, Inc., Caciqueco, Inc., Expressco, Inc., Lanco, Inc., Lernco, Inc., Limco Investments, Inc., Limtoo, Inc., Structureco, Inc., and V. Secret Stores, Inc.
D-86	Department's "Exhibit List" dated August 31, 1998.
D-87	Department's Initial Post-Hearing Brief dated March 1, 1999.
D-88	Department's Post-Hearing Response Brief dated May 3, 1999.
D-89	Departmental responses to Hearing Officer questions concerning Administrative Tax Hearing of The Limited Companies dated February 29, 2000.

Submitted by the Taxpayers:

TP-1	Booklet "Why Corporations Choose Delaware" by Lewis S. Black Jr.

TP-2	"Portfolio Print-Outs" for Expressco, Inc., Lernco, Inc., and Limco, Inc. dated May 18, 1998.
TP-3	Copies of various patent infringement litigation concerning A&F Trademark, Inc., Lanco, Inc., Limco Investments, Inc., and Expressco, Inc.
TP-4	Report entitled "North Carolina Corporate Income Tax Apportionment of Business Income" prepared by Richard W. Genetelli dated June 5, 1998.
TP-5	Report entitled "Nexus and State Corporate Income Taxation" prepared by David E. Wildasin dated June 1998.
TP-6	Report entitled "Economic Analysis of North Carolina Administrative Rule .0102" prepared by David L. Baumer.
TP-7	Report entitled "Testing a Related-Party Royalty for Adherence to the Arm's-Length Standard" prepared by Irving H. Plotkin dated June 1998.
TP-8	Report entitled "Royalty Rate Study – Licensing in the Consumer Goods Industry" prepared by Trademark & Licensing Associates, Inc. dated June 1998.
TP-9	Report entitled "Expert Opinion of Professor Richard D. Pomp."
TP-10	Excerpt from June 8, 1998 Tax Analysts, State Tax Today.
TP-11	Letter from M. Larry Stanfield, CPA, of the North Carolina Department of Revenue

	Interstate Audit Division to Cheri Rettstatt dated October 23, 1995.
TP-12	Letter from Hollis L. Hyans to Kay Miller Hobart, dated March 26, 1998.
TP-13	Letter from Jasper L. Cummings Jr. to Jack L. Harper dated June 4, 1998.
TP-14	Letter from Hollis L. Hyans to Hearing Officer Michael A. Hannah dated October 30, 1998.
TP-15	Letter from Hearing Officer Michael A. Hannah to Hollis L. Hyans dated December 16, 1998.
TP-16	Letter from Paul H. Frankel to Jack L. Harper dated December 30, 1998.
TP-17	Letter from Hollis L. Hyans to Hearing Officer Michael A. Hannah dated February 8, 1999.
TP-18	Chart regarding the physical presence and activities of Petitioners by location.
TP-19	Response by Professor David E. Wildasin to questions of the North Carolina Department of Revenue dated December 23, 1998.
TP-20	Petitioners' Initial Post-Hearing Brief dated March 1, 1999.
TP-21	Petitioners' Post-Hearing Answer Brief dated April 30, 1999.
TP-22	Petitioners' Sur-reply Brief dated June 28, 1999.
TP-23	Petitioners' responses to the Limited Hearing Questions dated February 29, 2000.

TP-24 Letter to Mr. Michael A. Hannah from Hollis Hyans dated April 12, 2000.

FINDINGS OF FACT

Based on the foregoing evidence of record, the Assistant Secretary makes the following findings of fact:

1. The Taxpayers are nine non-domiciliary corporations headquartered in Delaware.

2. The Taxpayers are wholly-owned subsidiaries of the Limited, Inc. ("Limited").

3. The Limited is primarily engaged in the nationwide retail sale of men's, women's, and children's clothing and accessories.

4. The Limited's principal place of business and commercial domicile is located in Columbus, Ohio.

5. The Limited started in business in 1963 and has expanded to over 5,000 stores nationwide and 12 separate retail operating subsidiaries.

6. The Limited and its retail operating subsidiaries ("related retail companies") own and operate all of their stores; none are franchised.

7. The Taxpayers own and license trademarks, tradenames, and service marks ("marks") and the goodwill associated with these marks to the Limited and its related retail companies, nine of which are located in North Carolina.

8. The nine related retail companies operating in North Carolina are: (1) The Limited Stores, Inc.; (2) Cacique, Inc.; (3) Express, Inc.; (4) Lane Bryant, Inc.; (5) Lerner, Inc.; (6) Limited Too, Inc.; (7) Structure, Inc.; (8) Victoria's Secret, Inc.; and (9) Abercrombie & Fitch.

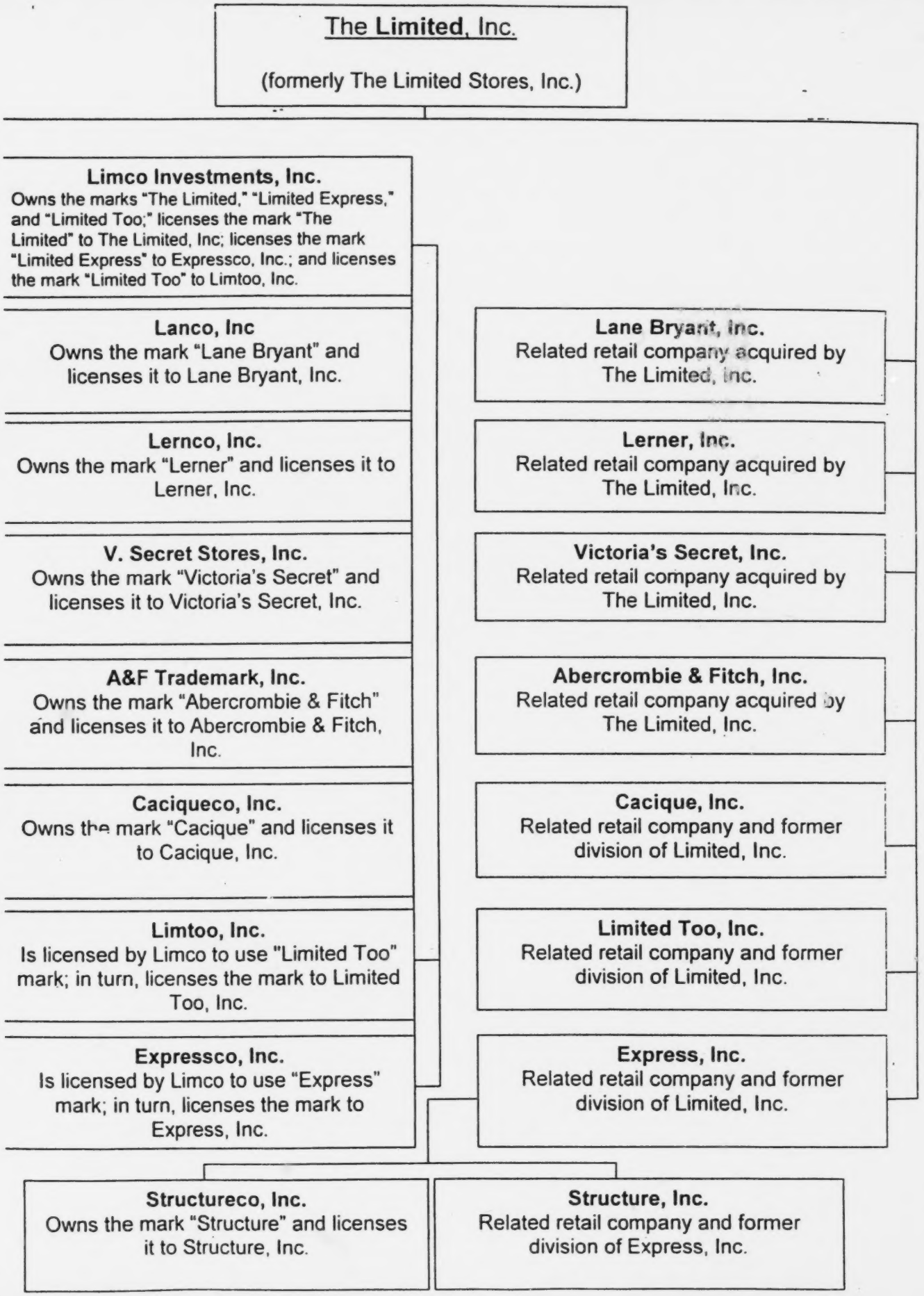
9. The nine related retail companies operating in North Carolina have over 130 retail locations in North Carolina; these companies extensively use the Taxpayers' marks at these locations.

10. The marks owned by the Taxpayers were all previously owned by either the Limited or one of the Limited's related retail companies.

11. The Taxpayers license their marks to the nine related retail companies operating in North Carolina as follows:

Taxpayer	Related Retail Company
Limco Investments, Inc.	The Limited, Inc.
Caciqueco, Inc.	Cacique, Inc.
Expressco, Inc.	Express, Inc.
Lanco, Inc.	Lane Bryant, Inc.
Lernco, Inc.	Lerner, Inc.
Limtoo, Inc.	Limited Too, Inc.
Structureco, Inc.	Structure, Inc.
V. Secret Stores, Inc.	Victoria's Secret, Inc.
A&F Trademark, Inc.	Abercrombie & Finch, Inc.

12. The structure of the Limited, the Taxpayers, and the related retail companies is illustrated on the following chart:


The Limited, Inc.
(formerly The Limited Stores, Inc.)
Limco Investments, Inc.
Owns the marks "The Limited," "Limited Express," and "Limited Too;" licenses the mark "The Limited" to The Limited, Inc; licenses the mark "Limited Express" to Expressco, Inc.; and licenses the mark "Limited Too" to Limtoo, Inc.
Lanco, Inc
Owns the mark "Lane Bryant" and licenses it to Lane Bryant, Inc.
Lernco, Inc.
Owns the mark "Lerner" and licenses it to Lerner, Inc.
V. Secret Stores, Inc.
Owns the mark "Victoria's Secret" and licenses it to Victoria's Secret, Inc.
A&F Trademark, Inc.
Owns the mark "Abercrombie & Fitch" and licenses it to Abercrombie & Fitch, Inc.
Caciqueco, Inc.
Owns the mark "Cacique" and licenses it to Cacique, Inc.
Limtoo, Inc.
Is licensed by Limco to use "Limited Too" mark; in turn, licenses the mark to Limited Too, Inc.
Expressco, Inc.
Is licensed by Limco to use "Express" mark; in turn, licenses the mark to Express, Inc.
Lane Bryant, Inc.
Related retail company acquired by The Limited, Inc.
Lerner, Inc.
Related retail company acquired by The Limited, Inc.
Victoria's Secret, Inc.
Related retail company acquired by The Limited, Inc.
Abercrombie & Fitch, Inc.
Related retail company acquired by The Limited, Inc.
Cacique, Inc.
Related retail company and former division of Limited, Inc.
Limited Too, Inc.
Related retail company and former division of Limited, Inc.
Express, Inc.
Related retail company and former division of Limited, Inc.
Structureco, Inc.
Owns the mark "Structure" and licenses it to Structure, Inc.
Structure, Inc.
Related retail company and former division of Express, Inc.

13. The Taxpayers purposefully utilize at least 130 retail locations in North Carolina to prominently display their marks, advertise apparel bearing their marks, and avail themselves of the North Carolina marketplace.

14. The Taxpayers' marks are permanently affixed to the 130 retail locations throughout North Carolina.

15. The related retail companies filed North Carolina franchise and income tax returns for the tax years January 1992 through January 1994 pursuant to G.S. 105-130 *et seq.*

16. The related retail companies reduced their North Carolina tax liability by deducting accrued royalty and interest expenses "paid" by journal entries to Taxpayers, thus producing substantial tax savings.

17. The Taxpayers accrued royalty and interest income on their books for tax years 1992 through 1994.

18. The Taxpayers did not file North Carolina franchise or income tax returns for tax years 1992 through 1994.

19. The Taxpayers did not pay any corporate income tax in Delaware or in any other state on their substantial royalty income and interest income deducted by the related retail companies.

Creation of Taxpayers

20. In its early years of operation, the Limited developed and cultivated intangible intellectual property including trademarks, tradenames, service marks, and associated goodwill.

21. Mr. Frank Colucci, Taxpayers' trademark counsel, testified that a trademark as defined under trademark law is "any name, word, symbol or device

which one manufacturer or provider of services uses to distinguish his goods or services from like goods or services of another." (T. 6/9/98, p. 232).

22. The Limited incurred substantial expenses in the development of its marks. The expenses were deducted from the Limited's gross income in the determination of its federal taxable income.

23. The Limited's North Carolina taxable income was also reduced by the expenses associated with the development of its marks because the Limited's North Carolina net income was based on its federal taxable income.

24. The value and significance of the trademark "The Limited" increased as the number of the Limited's stores increased.

25. All of the Limited's marks were registered, monitored, policed, and defended against infringement by the Limited's own in-house legal counsel prior to the formation of Taxpayers.

26. Officers of the Limited, including Mr. Kenneth Gilman, the Executive Vice-President and Chief Financial Officer of the Limited, concluded that the creation of a separate trademark holding company was the best way to protect the trademark from being "knocked off." (T. 6/9/98, p. 45).

27. The Limited's Board of Directors authorized the establishment of a separate trademark company to hold the trademark "The Limited."

28. On December 19, 1980, Articles of Incorporation were filed with the Delaware Secretary of State incorporating Limco Investments, Inc. ("Limco").

29. Limco held its first Board of Directors' meeting on January 29, 1981.

30. At this meeting, the Board authorized a tax-free exchange of assets for stock between the Limited and Limco in accordance with I.R.C. § 351, which is a common method of capitalizing subsidiaries.

31. Also on January 29, 1981, Limco issued 100 shares of its common stock, par value $1.00 per share, to the Limited for $100. In addition, the Limited made a $10,000 capital contribution to Limco.

32. The Limited became the sole shareholder of Limco.

33. By written Assignment dated January 28, 1981 The Limited assigned its marks and associated goodwill to Limco.

34. The Limited received little or no consideration for the transfer of its marks and goodwill to Limco.

35. The Limited did not have its trademark valued by a third party for a determination of the trademark's actual worth before assigning the trademark to Limco.

36. Both Limco and the Limited filed registration statements with the United States Patent and Trademark Office reporting the change in ownership of the trademark "The Limited" together with the goodwill established by the trademark from the Limited to Limco.

37. Limco did not register the trademark "The Limited" with the North Carolina Secretary of State's Office.

38. On January 29, 1981, the same day that the Limited assigned its marks and related goodwill to Limco, Limco and the Limited entered into a licensing agreement whereby Limco granted the Limited the right to use its marks in the Limited's retail operations.

39. Limco received, under the terms of the licensing agreement, royalties in the amount of 5% of the Limited's retail sales.

40. On January 29, 1981, the same day that the Limited assigned its marks and related goodwill to Limco, Limco and the Limited entered into a loan agreement whereby Limco agreed to loan the Limited money on a secured or unsecured basis, in an amount not to exceed $2,000,000. The loan agreement required the Limited to repay Limco any outstanding loan balance in 90 days and required the Limited to accrue and pay interest at the current prime rate.

41. The Limited acquired several retail establishments specializing in varying areas of apparel and began to operate these companies as wholly-owned subsidiaries. The acquired retail companies were: (1) Lane Bryant, Inc. ("Lane Bryant"), specializing in apparel for large size women; (2) Victoria's Secret, Inc. ("Victoria's Secret"), specializing in ladies' lingerie; (3) Lerner, Inc. ("Lerner"), specializing in women's apparel at a budget price; and (4) Abercrombie & Fitch, Inc. ("Abercrombie & Fitch"), specializing in upscale, casual clothing.

42. The marks owned by each of the acquired retail companies had name recognition and associated goodwill prior to acquisition of the retail companies by the Limited.

43. The Limited created separate trademark companies in a manner consistent with the tax-free creation of Limco.

44. The trademark holding company, Lanco, Inc. ("Lanco"), was incorporated in Delaware on December 15, 1982.

45. The retail company, Lane Bryant, assigned its trademark "Lane Bryant," together with the goodwill of the business symbolized by the trademark, to Lanco by a written Assignment recorded with United States Patent and Trademark Office.

46. Lane Bryant received little or no consideration from Lanco for its trademarks.

47. Lane Bryant did not have its trademark valued by a third party for a determination of the trademark's actual worth before assigning the trademark to Lanco.

48. The trademark holding company, Lernco, Inc. ("Lernco"), was incorporated in Delaware on May 2, 1985.

49. The retail company, Lerner, assigned its trademark "Lerner," together with the goodwill of the business symbolized by the trademark, to Lernco by written Assignment recorded with the United States Patent and Trademark Office.

50. Lerner did not have its trademark valued by a third party for a determination of the trademark's actual worth before assigning the trademark to Lernco.

51. Lerner received little or no consideration from Lernco for its trademarks.

52. The trademark holding company, A&F Trademark, Inc. ("A&F Trademark"), was incorporated in Delaware on February 2, 1988.

53. The retail company, Abercrombie & Fitch, assigned its trademark "Abercrombie & Fitch," together with the goodwill of the business symbolized by the trademark, to A&F Trademark by written Assignment recorded with the United States Patent and Trademark Office.

54. Abercrombie & Fitch received little or no consideration from A&F Trademark for its trademarks.

55. Abercrombie & Fitch did not have its trademark valued by a third party for a determination of the trademark's actual worth before assigning the trademark to A&F Trademark.

56. The trademark holding company, V. Secret Stores, Inc. ("V. Secret"), was incorporated in Delaware on December 1, 1988.

57. The retail company, Victoria's Secret, assigned its trademark "Victoria's Secret," together with the goodwill of the business symbolized by the trademark, to V. Secret by written Assignment recorded with the United States Patent and Trademark Office.

58. Victoria's Secret received little or no consideration from V. Secret for its trademarks.

59. Victoria's Secret did not have its trademark valued by a third party for a determination of the trademark's actual worth before assigning the trademark to V. Secret.

60. In addition to acquiring retail companies, the Limited developed its own retail companies by incorporating various business segments or divisions operated by the Limited. The retail divisions incorporated as wholly-owned subsidiaries of the Limited were: (1) Express, Inc. ("Express"), specializing in younger women's apparel; (2) Cacique, Inc. ("Cacique"), specializing in an older, more sophisticated type of lingerie; and (3) Limited Too, Inc. ("Limited Too"), specializing in clothing for young girls.

61. The trademark holding company, Expressco, Inc. ("Expressco"), was incorporated in Delaware on September 9, 1987.

62. On September 10, 1987, Expressco issued 100 shares of its common stock, par value $1.00 per share, to the trademark holding company, Limco, in exchange for $100. In addition, Limco made a $20,000 capital contribution to Expressco.

63. Also on September 10, 1987, Limco granted Expressco a non-exclusive license to use the tradename "Limited Express" or "Express" and the right to sublicense these tradenames to other companies.

64. Limco did not charge Expressco any royalty fee for the use of its mark "Express."

65. Limco did not have its trademark valued by a third party for a determination of the trademark's actual worth before licensing the trademark to Expressco.

66. The trademark holding company, Limtoo, Inc. ("Limtoo"), was incorporated in Delaware on August 1, 1991.

67. On December 31, 1991, Limtoo issued 100 shares of its common stock, par value $1.00 per share, to the trademark holding company, Limco, in exchange for $100. In addition, Limco made a $10,000 capital contribution to Limtoo.

68. Limco became the sole shareholder of Limtoo.

69. On September 9, 1991, Limco granted to Limtoo a non-exclusive license to use the trademark "Limited Too".

70. Limtoo licensed the tradename "Limited Too" from Limco, the Limited's wholly-owned subsidiary that owned the trademark.

71. Limco did not charge Limtoo any royalty fee for the use of its mark "Limited Too".

72. Limco did not have its trademark valued by a third party for a determination of the trademark's actual worth before licensing the trademark to Limtoo.

73. The trademark holding company, Structureco, Inc. ("Structureco"), was incorporated in Delaware on August 1, 1991.

74. On December 11, 1991, Structureco issued 100 shares of its common stock, par value $1.00 per share, to Express for $100. In addition, Express made a $20,000 capital contribution to Structureco.

75. Express is the sole shareholder of both Structure and Structureco.

76. On December 11, 1991, Express assigned the trademark "Structure" together with its associated goodwill to Structureco.

77. Also on December 11, 1991, Structureco licensed the tradename "Structure" to Express under the terms of a Related Company Agreement.

78. Structureco did not charge Express any royalty fee for the use of its mark "Structure".

79. Structureco did not have its trademark valued by a third party for a determination of the trademark's actual worth before licensing the trademark to Express or Structure.

80. The trademark holding company Caciqueco, Inc. ("Caciqueco") was incorporated in Delaware on August 1, 1991.

81. On September 9, 1991, Caciqueco issued 100 shares of its common stock, par value $1.00 per share, to the Limited for $100. In addition, the Limited made a $10,000 capital contribution to Caciqueco.

82. Also on September 9, 1991, the Limited assigned to Caciqueco the trademark "Cacique" together with its associated goodwill.

83. On January 1, 1991, Caciqueco licensed the trade name "Cacique" to Cacique under the terms of a Related Company Agreement.

84. The Limited did not have its trademark valued by a third party for a determination of the trademark's actual worth before assigning the trademark to Caciqueco.

85. All corporate formalities required by Delaware laws were observed in the creation of each Taxpayer.

86. Taxpayer and its corresponding related retail companies properly filed registration statements with the United States Patent and Trademark Office indicating the transfer to the Assignee of the right, title, and interest in the trademarks together with the goodwill of the business connected with the use of the marks.

87. The Taxpayers did not register their trademarks or tradenames with the North Carolina Secretary of State, relying instead on the registrations with the United States Patent and Trademark Office.

88. Upon the creation or acquisition of each Taxpayer and the tax-free assignment or grant of a license to use or sublicense the marks, each Taxpayer would license or sublicense the use of the marks back to the respective related retail company pursuant to a related company licensing agreement.

89. Each related company licensing agreement followed the format established by the original Limco licensing agreement.

90. Each related company licensing agreement entered into between a Taxpayer and the related retail company gave the related retail company a non-exclusive license to use the Taxpayer's trademarks, tradenames, service marks, and associated goodwill in its retail operations throughout the United States.

91. Each related company licensing agreement required the related retail company to pay the Taxpayer a set royalty fee based upon the related retail company's retail sales.

92. The related retail companies used Taxpayers' trademarks, tradenames, and service marks and their associated goodwill in North Carolina to promote and enhance their business in North Carolina.

93. Mr. Kenneth Gilman, President of all the Taxpayers, testified that Taxpayers' trademarks were sewn in the label of the clothes sold at the retail locations in North Carolina. (T. 6/9/98, p. 75).

94. The Taxpayers' marks were used by the related retail companies located in North Carolina in their store layout, their merchandising, and their advertising.

95. The Taxpayers' ownership of the marks did not affect the use of the marks in North Carolina in the eyes of the public consumer who continued to purchase apparel from the retail locations and who were unaware that the marks had been assigned to Taxpayers.

96. Mr. Kenneth Gilman testified that there were no changes in the relationship of the customer and the related retail companies as a result of the assignment of the marks to Taxpayers. (T. 6/9/98, pp. 149-150).

97. Mr. Kenneth Gilman testified that as long as a related retail company operated in accordance with the licensing agreements, the day-to-day operations of the related retail company did not change with the creation of Taxpayers and the assignment of the marks. (T. 6/9/98, pp. 148-149).

98. Neither the Taxpayers nor any of the related retail companies made any public announcements notifying the public of either the formation of Taxpayers or the assignment of the marks to Taxpayers.

99. The shareholders of the Limited were not notified that the marks and the goodwill associated with the marks had been assigned to Taxpayers.

100. Employees of the related retail companies were not notified that the marks and goodwill associated with the marks had been assigned to Taxpayers.

101. After the assignment of the marks, Taxpayers depended upon the same consumer recognition and customer loyalty for the production of their income that had existed prior to the transfer of the marks.

102. At no time during the audit period did the Limited's annual reports or its Form 10-Ks disclose the formation of Taxpayers or the transfer to Taxpayers of marks valued at approximately $1.2 billion dollars.

103. The Limited's January 30, 1993, Form 10-K included a footnote "A," which reads: "[T]he names of certain subsidiaries are omitted since such unnamed subsidiaries considered in the aggregate as a single subsidiary would not constitute a significant subsidiary as of January 30, 1993."

104. The Taxpayers were not listed as subsidiaries of the Limited on the January 30, 1993 Form 10-K.

105. Mr. Kenneth Gilman testified that the intercompany transactions occurring during the audit period between Taxpayers (producing over $1 billion in income) and the related retail companies (producing over $203 million in losses) were not significant enough to be disclosed in the footnotes of the Limited's annual report financial statements. (T. 6/9/98, pp. 117-123).

Organization of Taxpayers

106. Each of the Taxpayers elected a Board of Directors, the composition of which changed from time to time during the audit period.

107. The Board of Directors was generally the same for each Taxpayer.

108. The Taxpayers' Board of Directors consisted of Mr. Kenneth Gilman, President, Mr. Louis Black, an attorney, Mr. Roger Thompson, a banking executive, and Mr. Edward Jones, an accountant from Delaware Corporate Management.

109. Mr. Kenneth Gillman testified that he did not believe that he had attended a board meeting of the Taxpayers in over 10 years. (T. 6/9/98, p. 160).

110. Mr. Kenneth Gillman testified that he delegated his responsibilities as board member of the Taxpayers to Mr. Tim Lyons, Vice-President of Taxes for the Limited. (T. 6/9/98, pp. 56-57).

111. The Taxpayers compensated Board members not associated with the Limited for board meetings attended but did not compensate the Board members directly employed by the Limited.

112. Mr. Kenneth Gilman testified that neither he nor Mr. Tim Lyons as executives of the Limited were permitted

to receive compensation for services performed for any subsidiary of the Limited. (T. 6/9/98, p. 125).

113. Mr. Louis Black testified that each of Taxpayers' boards on which he served compensated him fifty dollars ($50) for each board meeting attended. (T. 6/9/98, pp. 208-209).

114. The Taxpayers' expenses associated with the compensation of board members averaged $600 per year per Taxpayer.

115. The Taxpayers' Board of Directors met quarterly and they discussed such things as royalty rates, interest rates, and the authorized lending limits between the Taxpayers and the related retail companies.

116. The Taxpayers' board members authorized increased lending limits for the related retail companies as needed when the balance of the related retail companies' outstanding notes receivable reached authorized lending limits.

117. The Taxpayers' Board of Directors meetings were held at Mr. Louis Black's office, not at the Taxpayers' leased office space.

118. The Taxpayers' corporate records, such as minutes, charters, and by-laws, were kept in Mr. Louis Black's office, not at the Taxpayers' leased office space.

119. The Taxpayers held annual stockholders' meetings as required by Delaware law and adopted appropriate resolutions, including the election of officers and directors.

120. The Taxpayers' officers or board members did not prepare yearly business plans for the operations of Taxpayers.

121. The Taxpayers did not own or lease any real property or any tangible personal property in any state except Delaware.

122. The Taxpayers subleased shared office space from Delaware Corporate Management in a building located in Delaware.

123. The Taxpayers shared office equipment and office supplies.

124. The Taxpayers' primary office address was 1105 Market Street, Delaware; approximately 670 companies not related to the Limited or its wholly-owned subsidiaries list this same address as their primary office address.

125. Mr. Louis Black testified that an employee of Delaware Corporate Management doing work for or on behalf of Taxpayers used Taxpayers' subleased office space, "if they [were] used by anyone at all." (T. 6/9/98; p. 227).

126. The Taxpayers' rental expense associated with the subleased office space in Delaware approximated $240 per year for each Taxpayer.

127. The subleased office space was not permanently assigned to Taxpayers, but instead was rotated much like a time share-arrangement.

128. The Taxpayers hired no employees in any state.

129. The Taxpayers outsourced all of their accounting, legal, banking and administrative services.

130. The law of [sic] firm of Morris, Nichols, Arsht & Tunnel, of which Mr. Louis Black was a partner, was hired as legal counsel for Taxpayers.

131. Delaware Corporate Management, of which Mr. Ed Jones was an employee, was hired as Taxpayers' accounting firm.

132. As board member and principal executive in charge of Taxpayers' accounting services, Mr. Ed Jones was limited to signing checks not to exceed $500.

133. The Taxpayers contracted with Mr. Frank Colucci of the firm Colucci & Umans as their trademark counsel.

134. The Taxpayers maintained checking accounts in their own names.

135. The Taxpayers used their checking accounts to pay operating expenses such as legal and accounting bills.

136. The Taxpayers did not incur substantial ordinary and necessary business expenses such as postage, telephone, or utilities for their business operations in Delaware.

137. The Taxpayers contracted with Delaware Corporate Management, a "nexus service provider" to perform services on their behalf in Delaware.

138. Services performed by Delaware Corporate Management for the Taxpayers included: (1) providing officers and directors located in the State of Delaware; (2) providing office space; (3) mail forwarding; (4) filing annual Delaware Franchise Tax Returns; (5) maintaining the operating checkbook; and (6) scheduling use of a shared conference room.

Operations of the Taxpayers

139. The Taxpayers' Board of Directors agreed to license their marks to the related retail companies pursuant to licensing agreements.

140. The Taxpayers' trademark counsel, Mr. Frank Colucci, assisted in drafting licensing agreements between the Taxpayers, as licensor, and the related retail companies, as licensees.

141. Mr. Frank Colucci testified that all of the Taxpayers' licensing agreements were basically the same in terms of the legal requirements imposed on both the licensee and licensor. (T. 6/9/98, p. 243).

142. Each licensing agreement granted the related retail company a non-exclusive license to use all of the Taxpayer's marks in its retail operations.

143. The terms of each licensing agreement required the related retail company to pay a royalty fee of between 5% and 6% of its retail operating gross sales to Taxpayers in return for continued use of the marks.

144. Each licensing agreement allowed the related retail company to continue using the Taxpayer's name in conducting its business in the same manner as before the creation of the Taxpayer.

145. Initially, the royalty rates charged by the Taxpayers to the related retail companies were estimated by Taxpayers' trademark counsel based upon his knowledge of licensing agreements between unrelated third parties and what he believed to be a reasonable royalty based on a fair, arms-length transaction.

146. Dr. Irving Plotkin, the Taxpayers' expert witness, testified that: "When you deal with a transaction between a related party, the transaction itself is not arm's length. It cannot be – it could not have come about by an arm's length negotiation." (T. 6/11/98, pp. 68-69).

147. Dr. Plotkin testified that: "The [intercompany] agreement should have never been described as an arm's length agreement, because [it] couldn't have been." (T. 6/11/98, p. 70).

148. The Taxpayers eventually solicited trademark valuation studies from third parties which they used to establish the royalty rate charged.

149. The Taxpayers were required on occasion to amend the royalty rates charged to the related retail companies to correspond with the royalty rates determined by the third party valuation studies.

150. The value of the marks as determined by the trademark valuation reports were dependent upon the "on-going" retail operations of the related retail companies.

151. The royalty rate charged to the related retail companies as determined by the trademark valuation reports was between 5% and 6%.

152. The Taxpayers were completely dependent upon the operations of the related retail companies, including the ones located in North Carolina, for the production of their income because the royalty rates charged by the Taxpayers were based on a percentage of the related retail companies' operating sales.

153. A royalty fee was not charged for the use of the marks when a license or sublicense agreement was entered into between two Taxpayers.

154. Neither the Limited nor any of its subsidiaries licensed or sublicensed marks to foreign subsidiaries.

155. The Taxpayers' Profit and Loss Statements for the years at issue did not include any foreign source royalty income.

156. Royalty income received from foreign subsidiaries is considered gross income and fully taxable for federal corporate income tax purposes pursuant to I.R.C. § 951.

157. The only time the Taxpayers, as licensors, charged a royalty fee for the use of their marks to an affiliated company, as a licensee, was when a state tax benefit could be obtained by the licensee.

158. Each licensing agreement entered into between a related retail company, as licensee, and a Taxpayer, as licensor, required the related retail company to make quarterly royalty payments for the use of the trademarks.

159. The related retail companies did not pay the royalty fees to Taxpayers or tender any cash remittances to Taxpayers in settlement of the royalties charged.

160. Each related retail company accrued a royalty expense deduction based on a percentage of sales.

161. Mr. Kenneth Gilman testified that the royalty payments due under the licensing agreements were made by accounting journal entry. No checks were written nor were there any physical transfers of funds between the parties. The related retail companies therefore "paid" their royalty fees to Taxpayers via accounting journal entries. (T. 6/9/98, p. 93).

162. The North Carolina taxable income of each of the related retail companies was significantly reduced by the deduction of accrued royalty expenses.

163. The Taxpayers accrued but never received payment for royalties from the respective related retail companies.

164. The accrued royalty receivables for each of the Taxpayers increased on a yearly basis corresponding

closely to the amount of accrued royalty payables recorded on the books of the related retail companies.

165. The related retail companies' accrued royalty receivables were never collected.

166. The Taxpayers paid no state income tax to Delaware or any state on the accrued royalty receivables.

167. The Taxpayers' expenses were miniscule in relation to their accrued income. For example, Limco's total expenses for the three years at issue were $729,175, which is 0.2% of its total accrued income of $311,952,574 during the same period. Of Limco's total expenses, legal expenses alone equaled $687,754 or 94.32% of total expenses.

168. Limco's remaining expenses of $41,421 for the three years at issue were immaterial and are summarized as follows: (1) Delaware franchise fees – $150; (2) accounting services – $31,052; (3) telephone expenses – $1,102; (4) rental expenses – $ 720; (5) Director's fees – $2,300; (6) custodial expenses to Delaware Trust Management – $3,520; (6) depreciation expenses – $1,862; (7) other miscellaneous expenses – $714.

169. The Taxpayers neither declared nor paid a dividend to the Limited or to any of the related retail companies during the audit period.

170. The Taxpayers entered into loan agreements whereby Taxpayers loaned their excess operating funds to the related retail companies in the form of notes receivable.

171. Mr. Kenneth Gilman testified that the primary source of lending to the related retail companies was the earnings of Taxpayers. (T. 6/9/98, pp. 105-106).

172. Mr. Louis Black testified that Taxpayers earned their money by charging the related retail companies royalties for the use of Taxpayers' marks and by receiving interest through loaning the related retail companies money. (T. 6/9/98, p. 179).

173. The Taxpayers' Board of Directors, including Mr. Louis Black, authorized loans to the related retail companies in amounts comparable to the cumulative amount of royalties the related retail companies accrued during the tax year.

174. Despite authorizing loans to the related retail companies in excess of $100 billion, Taxpayers' Board Member, Mr. Louis Black, testified that he had not reviewed the Limited's 10-K or its annual reports. (T. 6/9/98, p. 201).

175. The notes, which were generally 180-day promissory notes, contained standard provisions such as loan amount, interest rate, due date, and names of the parties.

176. All notes bore a market rate of interest.

177. The Taxpayers earned interest income on the notes to the related retail companies.

178. The related retail companies did not pay any outstanding principal or interest on the notes to the Taxpayers during the audit period.

179. The related retail companies accrued an interest expense deduction on their outstanding notes receivable.

180. The interest charges were settled by accounting journal entries.

181. As notes matured, the Taxpayers made the required journal entries and issued new notes to the related retail companies.

182. The Taxpayers' Board of Directors increased the authorized lending limits of the related retail companies once the related retail companies' outstanding notes receivable balances reached authorized limits.

183. The notes receivable contained no mechanism by which the Taxpayers could collect the loan debt from the related retail companies.

184. The Taxpayers made no attempt at collecting the outstanding notes receivable during the audit period.

185. The Taxpayers instructed their custodian, Wilmington Trust, to make no attempt to collect the outstanding notes.

186. The Taxpayers' Yearly Statements of Account reflecting the asset value of Taxpayers' outstanding notes were marked "Notes – Do Not Collect."

187. The Taxpayers did not loan money to or borrow money from any unrelated third party.

188. The North Carolina taxable income of the related retail companies was reduced by the deduction of the accrued royalty and interest expenses that were never paid.

189. The Taxpayers paid no state income tax to Delaware or any state on the royalty or interest income.

190. The Taxpayers earned 100% of their ordinary gross income from two sources: (1) the royalties charged to the related retail companies for the use of Taxpayers'

marks and (2) interest earned from outstanding loans issued to the related retail companies.

191. The Taxpayers recorded royalty income totaling $957,442,830 and interest income totaling $236,728,978 from the related retail companies for the tax years at issue, broken down as follows:

YEAR	ROYALTY INCOME	INTEREST INCOME
1/92	$ 298,494,228	$ 58,610,029
1/93	349,880,983	56,087,605
1/94	301,067,619	122,031,344
Total	**$949,442,830**	$ **236,728,978**

192. Pursuant to I.R.C. § 1501, the Taxpayers filed a consolidated federal income tax return with their parent, the Limited, for tax years ended January 1992, January 1993, and January 1994.

193. The intercompany royalty and interest transactions that occurred between Taxpayers and the related retail companies had no tax effect on the federal taxable income of the Limited because of required intercompany eliminations.

194. The intercompany royalty and interest transactions that occurred between Taxpayers and the related retail companies significantly decreased the North Carolina taxable income of the related retail companies.

The Licensing Agreements

195. The Taxpayers had incurred none of the costs and had performed none of the activities that, in any manner, had created, enhanced, or protected the value of the marks prior to the assignment of the marks to Taxpayers.

196. "Naked assignment" is a term used in trademark law that describes the assignment of a trademark without its associated goodwill.

197. Mr. Frank Colucci, Taxpayers' trademark counsel, testified that it is illegal in the United States to assign trademarks without assigning the goodwill associated with the trademarks. (T. 6/9/98, p. 279).

198. Mr. Frank Colucci testified that goodwill is an accumulation of everything that the public perceives about a trademark – good, bad, or indifferent (T. 6/9/98, p. 280).

199. Mr. Frank Colucci testified that the goodwill the Taxpayers' assigned to the related retail companies had been created by the related retail companies. (T. 6/9/98, p. 280).

200. Mr. Frank Colucci testified that, after the assignment of the marks to the Taxpayers, the only way to maintain the goodwill associated with the marks was to use the marks. Mr. Frank Colucci stated that, "You use the trademark and, through the use of the trademark, you either maintain the goodwill or you don't maintain the goodwill." (T. 6/9/98, p. 280).

201. Mr. Frank Colucci testified that the trademarks were used by the related retail companies wherever they had stores and businesses. (T. 6/9/98, p. 280).

202. If Taxpayers did not take appropriate measures to monitor the related retail companies' use of their marks, Taxpayers risked abandonment of their marks, thereby enabling third parties to use the marks in whatever manner they desired.

203. The trademark law concept of "naked licensing" requires the owner of a trademark that permits another company to use its trademark to ensure that

the public is not deceived with respect to the nature and quality of the goods sold under the mark.

204. Mr. Frank Colucci testified that a licensing agreement is the contractual basis by which the licensor of a trademark or tradename controls the nature and quality of the goods and services sold by a licensee using the trademark or tradename. (T. 6/9/98, p. 241).

205. Mr. Frank Colucci testified that a court could invalidate a mark and refuse to enforce a mark if the owner of the mark does nothing to protect the public trust with respect to the nature and quality of the goods sold under the mark. (T. 6/9/98, p. 237).

206. Mr. Frank Colucci testified that "the whole idea of having a related company [licensing agreement is] that there be controls over an *agent* quality of the goods . . . so that the public being accustomed with a mark being used on one line of goods or services, now that it was given to another company, would not be confused or deceived." (emphasis added) (T. 6/9/98, pp. 236-237).

207. The Taxpayers relied upon the related retail companies to ensure that the public was not deceived with respect to the nature and quality of goods sold under Taxpayers' marks.

208. The Taxpayers, owners of the marks, controlled the use of the marks in North Carolina and the nature and quality of goods sold under the marks by the related retail companies in North Carolina.

209. The related retail companies performed activities in North Carolina on behalf of the Taxpayers, including the following: (1) the preparation of quarterly inspection reports regarding the activities of the retail location; (2) establishment of store layout and design;

(3) selecting the merchandise that would bear Taxpayers' marks; (4) regularly advertising apparel and merchandise in this State bearing Taxpayers' marks; (5) inspecting merchandise bearing Taxpayers' marks; (6) reporting trademark violations; and (7) establishing and maintaining Taxpayers' economic market in North Carolina.

210. The activities performed in North Carolina on behalf of the Taxpayers were significantly associated with Taxpayers' ability to establish and maintain a market in North Carolina.

211. Mr. Kenneth Gilman testified that: "[I]t's important to protect the trademark because it's the identity of the company. It's one of the ways that you differentiate what you are as a company and what you represent; what you're selling; what you're trying to accomplish in a commercial marketplace from other people." (T. 6/9/98, p. 71).

212. The Taxpayers' commercial marketplace was in part located in North Carolina.

213. The Taxpayers' marks were displayed on the North Carolina retail locations of the related retail companies.

214. The related retail companies' activities, including marketing products bearing Taxpayer's trademarks and tradenames, maintaining the quality of the apparel sold under Taxpayers' marks, and otherwise providing retail customers with a quality shopping experience, inures to and enhances the value of Taxpayers' trademarks and tradenames in North Carolina.

215. Mr. Frank Colucci testified that he monitored "how the trademarks [were] used by the retailers" in his capacity as trademark counsel for both Taxpayers

and the related retail companies. (T. 6/9/98, pp. 254-255).

216. Mr. Frank Colucci testified that representatives of the retailers as well as representatives of Taxpayers sent Mr. Frank Colucci or Mr. Frank Colucci's staff into the retail stores to monitor the use of Taxpayers' trademarks by the related retail companies. (T. 6/9/98, p. 260).

217. The Taxpayers, as owners of the marks, had the power to determine which retail companies used their marks and where they could be used.

218. The Taxpayers, as owners of the marks, had the power to control to whom the marks were licensed, what license fees were charged, and when the licensing agreements expired.

219. The Taxpayers, as owners of marks, had the right to dictate the manner in which the trademarks and tradenames were displayed at the retail locations throughout North Carolina.

220. The Taxpayers knowingly and purposefully granted the retail companies a license to use their marks in connection with retail operations worldwide, including in North Carolina.

221. The licensing agreements provided that all products sold by the related retail companies bearing Taxpayers' trademarks and tradenames had to be consistent with the high standards of quality and excellence established over the years by the related retail companies with respect to their trademarks and tradenames.

222. Sections 2.1 through 2.3 of the licensing agreements provided that Taxpayers' trademarks or tradenames had to be used by the related retail companies in accordance with the following terms and conditions:

(1) the retailer would use its best efforts, skill, and diligence in the operation of its Stores, and would regulate its employees so that they will be courteous and helpful to the public; (2) the retailer would use its best efforts, skill, and diligence to ensure that the quality of all apparel sold under or in connection with the trademark or tradenames would not be less than the standard of quality previously established by the retail companies; and (3) the retailer would operate its stores in accordance with reasonable business standards and would provide a standard of service not less than the standard of quality previously established by the retail companies.

223. Section 3.1 of the licensing agreements provided that each retail store operated by a related retail company had to inspect the store at least once each year and had to notify Taxpayers of the inspections in a written statement verifying that the inspections took place.

224. The Taxpayers did not physically inspect any stores in North Carolina and rarely, if ever, visited any store outside of Delaware.

225. Store employees at the North Carolina retail locations of the related retail companies acted as quality assurance inspectors and performed all inspections of apparel bearing Taxpayers' marks to ensure the quality of the goods sold under Taxpayers' marks in North Carolina.

226. The North Carolina retail operating store employees, in their capacity as quality assurance inspectors, prepared inspection reports based on the operations of the related retail companies in this State.

227. Mr. Kenneth Gilman testified that the employees of the related retail companies performed inspections of the stores located in North Carolina in order to

adhere to quality standards mandated by the licensing agreements and to demonstrate compliance with the licensors' requirements. (T. 6/9/98, pp. 86-88).

228. Section 3.1.2 of the licensing agreements provided that the related retail companies were responsible for, at their own cost and expense, correcting any deficiencies found in the quality of the products sold bearing Taxpayers' trademarks.

229. Section 4 of the licensing agreements provided that the related retail companies had to make available to Taxpayers samples of all advertising or other literature, packages, and labels bearing Taxpayers' tradename or trademarks.

230. Mr. Frank Colucci testified that he monitored all advertising associated with Taxpayers' trademarks and tradenames in his capacity as trademark counsel for both the related retail companies and Taxpayers. (T. 6/9/98, pp. 254-255).

231. In reviewing the advertising samples submitted by the related retail companies, Mr. Frank Colucci looked to ensure that Taxpayers' marks were used in a consistent manner and to ensure that the use did not infringe on other marks.

232. Section 11.1 of the licensing agreements required the related retail company to defend Taxpayers' marks against infringement by third parties at its own cost and expense.

233. Section 11.2 of the licensing agreements provided that if the related retail company was made party to a legal proceeding based upon a claim that one of Taxpayers' marks infringed upon a third party's mark, the related retail company had to, at its own cost and expense, defend its use of the licensed mark.

234. Prior to the formation of Taxpayers, the marks associated with the related retail companies were registered, monitored, and defended against infringement by the related retail companies themselves.

235. The Taxpayers continually updated the trademark filings and registrations with the United States Patent and Trademark Office in order to ensure that Taxpayers' rights in the marks were preserved.

236. Mr. Frank Colucci testified that his office filed with the United States Patent and Trademark Office every six years an affidavit "saying that [the] trademarks [were] still in use. Otherwise, [the trademarks would] be automatically cancelled." (T. 6/9/98, pp. 262-263).

237. Mr. Kenneth Gilman, President of the Limited, testified that the related retail companies located in North Carolina used Taxpayers' marks on a daily basis. (T. 6/9/98, pp. 74-75).

The Assessments

238. The Limited was contacted in March, 1995 by Mr. Al Milak, Revenue Field Auditor in the Interstate Audit Division, regarding the activities of the Limited and its affiliates in this State.

239. An on-site audit for corporate franchise and income tax was conducted in August 1995.

240. The auditors determined that Taxpayers, subsidiaries of the Limited, were doing business in this State and subject to corporate income and franchise taxation in this State pursuant to G.S. 105-114, 105-122, 105-130.1, and 105-130.3.

241. The Taxpayers were not filing corporate franchise and income tax returns.

242. The auditor requested on October 23, 1995 that Taxpayers file and pay North Carolina franchise and income tax, apportioning their income liability to this State as an excluded corporation pursuant to G.S. 105-130.4(a)(4) and 105-130.4(r).

243. The Taxpayers did not voluntarily file North Carolina franchise and income tax returns and refused to provide the auditors with sufficient information necessary to compute Taxpayers' North Carolina corporate liability.

244. Jeopardy assessments of corporate income and franchise taxes were issued for tax years January 1992, January 1993, and January 1994 under the authority of G.S. 105-241.1(g) on March 26, 1996 and on April 2, 1996.

245. The Taxpayers were assessed income and franchise taxes calculated on royalty and interest income derived from sources within North Carolina.

246. For each Taxpayer during the audit period, the franchise assessments of tax, penalties, and interest are as follows:

Franchise Tax Assessments

A&F Trademark, Inc.	$ 3,963
Caciqueco, Inc.	$ 1,025
Expressco, Inc.	$ 37,264
Lanco, Inc	$ 37,296
Lernco, Inc.	$ 31,949
Limco Investments, Inc.	$ 124,966
Limtoo, Inc.	$ 44,142
Structureco, Inc.	$ 1,071
V. Secret Stores, Inc.	$ 27,176
Total	**$ 308,852**

247. For each Taxpayer during the audit period, the corporate income tax assessments of tax, penalties, and interest are as follows:

Income Tax Assessments

A&F Trademark, Inc.	$ 116,401
Caciqueco, Inc.	$ 58,452
Expressco, Inc.	$ 953,765
Lanco, Inc	$ 580,231
Lernco, Inc.	$ 766,775
Limco Investments, Inc.	$ 1,331,052
Limtoo, Inc.	$ 128,766
Structureco, Inc.	$ 82,479
V. Secret Stores, Inc.	$ 666,909
Total	**$ 4,684,830**

248. The jeopardy income tax assessments were based on the best information available to the auditor. That information was Taxpayers' separate entity, "pro-forma" federal taxable income, Federal Line 28, as reflected on the Limited's consolidated 1120 tax return.

249. The proposed assessments were based on the State's assertion that Taxpayers were doing business in North Carolina by virtue of their activities of licensing intangibles for use in North Carolina and using in-state representatives in furtherance of their business activities.

250. On April 22, 1996, Taxpayers timely protested the proposed corporate income and franchise tax assessments and reserved the right to a hearing before the Secretary of Revenue.

251. An application for hearing was timely filed on August 18, 1997.

252. An Administrative Tax Hearing before the Secretary of Revenue was conducted by the hearings' officer on

Monday, June 9 through Wednesday, June 11, 1998 in the Revenue Building on 501 North Wilmington Street.

253. On June 11, 1998, the hearings' officer granted Taxpayers' motion to waive all penalties associated with all three tax years at issue.

CONCLUSIONS OF LAW

Based on the foregoing findings of fact, the Assistant Secretary makes the following conclusions of law:

1. The Taxpayers are subject to corporate income taxation in this State pursuant to G.S. 105-130 *et seq.*

2. The Taxpayers are subject to franchise taxation in this State pursuant to G.S. 105-114 *et seq.*

3. G.S. 105-130.3 imposes a tax upon the State net income of every C corporation doing business in this State.

4. The Taxpayers are C corporations.

5. G.S. 105-122 imposes a franchise tax upon every corporation domesticated under the laws of this State or doing business in this State.

6. The Taxpayers are not domesticated under the laws of this State.

7. For franchise tax purposes, "doing business" is defined as "[e]ach and every act, power or privilege exercised or enjoyed in this State, as an incident to, or by virtue of the powers and privileges granted by the laws of this State."

8. North Carolina Administrative Rule 17 NCAC 5C .0102 was promulgated by the Secretary of Revenue

under authority of G.S. 105-262 and 105-264 to interpret G.S. 105-130.3.

9. Administrative Rule 17 NCAC 5C .0102 is *prima facie* correct.

10. Administrative Rule 17 NCAC 5C .0102 defines "doing business," in pertinent part, as "the operation of any business enterprise or activity in North Carolina for economic gain, including, but not limited to . . . the owning, renting, or operating of business or income-producing property in North Carolina including, but not limited to . . . [t]rademarks [and] tradenames."

11. The Taxpayers own intangible property in the form of trademarks, tradenames, and service marks and the goodwill associated with these marks.

12. There is no such thing as property in a trademark except as a right appurtenant to an established business or trade in connection with which the mark is employed.

13. A trademark has no independent significance apart from the goodwill it symbolizes; if there is no established business and no goodwill, a trademark symbolizes nothing.

14. A trademark cannot exist apart from the going business in which it is used.

15. Trademark rights are wholly dependent upon actual use.

16. The actual use of a symbol as a trademark in the sale of goods creates and builds up rights in a mark.

17. Lack of actual use can result in loss of legal rights in the mark, known as "abandonment."

18. The Taxpayers licensed their intangible property, in the form of trademarks, tradenames, service marks and associated goodwill, to the related retail companies for use in this State.

19. If a trademark owner licenses the mark, the owner must control the nature and quality of the goods sold under the mark and must at all costs avoid deceiving the public.

20. The concept of quality control has been incorporated into the Lanham Act by the "related company" doctrine.

21. Under the Lanham Act, a "related company" is "any person whose use of the mark is controlled by the owner of the mark with respect to the nature and quality of the goods or services on or in connection with which the mark is used."

22. If the owner controls the use of the mark by the licensee, the owner obtains the benefits of Section 5 of the Lanham Act, and the licensee's use of the mark is attributed to and inures to the benefit of licensor, the owner of the mark.

23. If the owner of a trademark does not exercise sufficient actual control over the use of the mark by the licensee, the owner loses its rights in the mark through abandonment.

24. The trademark owner must exercise *actual* control over the licensee's use of the mark. Mere paper control, such as a quality control provision in a licensing agreement, without actual control is insufficient. The mere legal right to control is insufficient, as is the voluntary exchange of information.

25. Under the related company doctrine, if the Taxpayers exercised sufficient actual control over the operations of the related retail companies in North

Carolina with regard to their use of the marks and the nature and quality of the goods sold under the marks, the use by the related retail companies in North Carolina is attributed to and inures to the benefit of the Taxpayers.

26. Absent sufficient actual control by the Taxpayers over the related retail companies' use of the marks in North Carolina and the nature and quality of the goods sold under the marks in this State, the use of the marks by the related retail companies is not attributed to the Taxpayers.

27. If use by the related retail companies of Taxpayers' marks is not attributed to Taxpayers, the marks would be abandoned.

28. The licensing agreements between Taxpayers and the related retail companies created a contractual agency relationship between Taxpayers and the related retail companies.

29. The Taxpayers exercised actual control over the licensees' use of the marks at the 130 North Carolina retail locations and over the nature and quality of the goods sold under the marks by the licensees at these locations.

30. The related retail companies are "related retail companies" under the related company doctrine of trademark law.

31. The related retail companies regularly and systematically used the Taxpayers' marks at the 130 retail locations in North Carolina.

32. The intangibles owned by the Taxpayers and used at the 130 retail locations in this State have acquired a business situs in North Carolina.

33. The Taxpayers own income-producing property in North Carolina.

34. The regular and systematic use of the Taxpayers' marks by the related retail companies at the 130 retail locations in North Carolina is attributed to and inures to the benefit of Taxpayers, thereby protecting and preserving the value and existence of the marks and associated goodwill, Taxpayers' only assets.

35. The use of Taxpayers' marks by the related retail companies in North Carolina is essential to the continued existence of the marks.

36. The quality control and trademark protection activities performed by employees of the related retail companies in North Carolina to protect Taxpayers' marks are attributed to and inure to the benefit of Taxpayers.

37. The activities performed by employees of the related retail companies in North Carolina to assist in maintaining the goodwill associated with Taxpayers' marks are attributed to and inure to the benefit of Taxpayers.

38. The related retail companies, in performing the activities of quality control and protection and preservation of Taxpayers' marks and associated goodwill, act as Taxpayers' agents or representatives in North Carolina.

39. The activities of the related retail companies, acting as Taxpayers' agents or representatives, enable Taxpayers to maintain and enhance a market in this State for merchandise bearing Taxpayers' marks.

40. The Taxpayers' primary source of income, the royalty fees, is dependent upon business activity conducted

by employees of the related retail companies in North Carolina, which activity Taxpayers control.

41. The Taxpayers purposefully availed themselves of the benefits of an economic market in North Carolina.

42. The Taxpayers regularly and systematically exploited the North Carolina marketplace for economic gain.

43. The Taxpayers' business activities were purposefully directed towards residents of North Carolina.

44. The Taxpayers operate income-producing business property in North Carolina.

45. The Taxpayers are operating a business activity or enterprise in this State for economic gain.

46. The Taxpayers are "doing business" in this State for corporate income tax purposes.

47. The Taxpayers are "doing business" in this State for corporate franchise tax purposes.

48. The Taxpayers received more than 50% of their income from investments in or dealing in intangible property.

49. The Taxpayers are "excluded corporations" under G.S. 105-130.4(a)(4).

50. The Taxpayers must apportion their business income using the sales factor as determined under G.S. 105-130.4(a)(1).

51. The proposed assessments of corporate income and franchise tax were proper under G.S. 105-241.1.

DECISION

I. SUMMARY OF FACTS

This case involves nine non-domiciliary corporations ("Taxpayers") that own trademarks, tradenames, service marks ("marks"), and the goodwill associated with these marks. This intangible property was transferred to the Taxpayers from their retail affiliates ("related retail companies"). The Taxpayers are wholly-owned subsidiaries of the Limited Stores, Inc. ("Limited"), an Ohio corporation. The related retail companies consist of the Limited and eight wholly-owned subsidiaries of the Limited. The chart in Finding Of Fact #12 shows the relationships between these companies. The related retail companies are located in this State and pay corporate income and franchise taxes here.

The Taxpayers were incorporated in Delaware to hold the marks formerly owned by the Limited and its various wholly-owned retail subsidiaries. The marks owned by the Taxpayers include "The Limited," "Limited Too," "Victoria's Secret," "Express," ["]Structure," "Cacique," "Abercrombie & Fitch," "Lane Bryant," and "Lerner." The marks are a form of intangible personal property. The Taxpayers do not own or lease any real property or any tangible personal property in any state except Delaware. The Taxpayers do not have any employees in any state.

The Taxpayers received the marks they own in separate I.R.C. § 351 tax-free exchanges with the related retail companies. In these exchanges, the related retail companies transferred the marks to the Taxpayers for little or no consideration. The Taxpayers then entered into licensing agreements with the related retail companies authorizing

the related retail companies to use the marks in exchange for royalty payments to Taxpayers.

During the years at issue, the Limited was primarily engaged in the retail sale of men's, women's, and children's clothing and accessories throughout the United States, including North Carolina. During these years, the Limited and its related retail companies operated over 130 retail locations in North Carolina. On a daily basis, these 130 plus retail locations used the Taxpayers' marks in their signage, store layout, merchandising, and advertising. The Taxpayers' marks, for example, were permanently affixed to these retail locations. In addition, these locations performed various activities on behalf of Taxpayers needed to protect the marks in accordance with trademark law and to maintain and enhance a market for merchandise bearing Taxpayers' marks. These activities included selecting merchandise to bear Taxpayers' marks and inspecting the merchandise to ensure appropriate quality.

The corporate structure of the Taxpayers developed over a number of years. In the early 1970's, at a time when specialty retailing was emerging, the Limited began taking a strong position in what was termed a "private label." Instead of purchasing nationally-branded goods from the garment district in New York, the Limited had goods produced with its own label, its trademark, sewn inside the garment. In the course of its retail operations, the private label, "The Limited," developed name recognition within the apparel industry. The Limited incurred substantial expenses in the development of "The Limited" trademark, which were deducted from the Limited's gross income in determining its federal taxable income. The Limited's North Carolina taxable income was also reduced by the expenses associated with the development of its

marks because the Limited's North Carolina net income was derived from federal taxable income.

In December 1980, the Limited formed a wholly-owned subsidiary, Limco Investments, Inc. ("Limco"), in Delaware and transferred its domestic (United States) marks, together with the goodwill associated with the marks, to Limco for 100 shares of Limco's $1.00 par value common stock using I.R.C. § 351. Limco then licensed the trademarks back to the Limited for use in the Limited's domestic operations and charged the Limited a royalty to use the marks based on a percentage of the Limited's retail sales.

Initially, a royalty rate of 5% was determined to be reasonable by Taxpayers' trademark counsel based on his experience with third-party licensing agreements. At a later date, the Taxpayers solicited trademark valuation studies from third parties in order to prevent the appearance of the transactions being "shams" or not being arms-length. The royalty rate for the trademark "The Limited" was determined by the third party to be 6%. The Taxpayers did not receive an initial trademark valuation from third parties determining the actual worth of the trademark prior to the assignment and license back of the marks between the Taxpayers and the related retail companies.

Subsequent to the formation of Limco in late 1980, the Limited acquired other retail businesses that owned trademarks, tradenames, and service marks. Those businesses were Lane Bryant, Lerner Stores, Victoria's Secret Stores, and Abercrombie & Fitch. As was the case with Limco, the Limited incorporated four separate

subsidiaries, Lanco, Inc. ("Lanco"), Lernco, Inc. ("Lernco"), V. Secret Stores, Inc. ("V. Secret"), and A&F Trademark, Inc. ("A&F Trademark") to hold the marks of those acquired businesses. In separate transactions, the related retail companies transferred their domestic (United States) marks to the Taxpayers, together with the goodwill associated with the marks, for little or no consideration. The Taxpayers then licensed the marks back to the related retail companies for use in the related retail companies' stores. These marks were actively used by the related retail companies located in North Carolina both prior to and after the tax-free exchanges.

After assigning their domestic (United States) marks to the Taxpayers, the related retail companies, pursuant to related company licensing agreements, licensed back the marks from the Taxpayers for use in their retail operations in the same manner in which they had been used prior to the transfer. In fact, at the retail locations, nothing changed with the transfer of the marks to Taxpayers. The licensing agreements executed by the Taxpayers and the related retail companies required the related retail companies to pay the Taxpayers a royalty fee based on a percentage of the companies' retail operating gross sales. The royalty rate charged by the Taxpayers to the related retail companies for the years at issue was between 5% and 6%. During the fiscal years ended January 31, 1992 through January 31, 1994, the Taxpayers recorded total royalty income received from the related retail companies in the amount of $949,442,830.

In separate transactions, the Taxpayers loaned money earned from the royalty payments back to the related retail companies for use in their retail operations. The loan agreements allowed the Taxpayers to charge the

related retail companies a market rate of interest on outstanding loan balances. During the fiscal years ended January 31, 1992, through January 31, 1994, the Taxpayers recorded total interest income received from the related retail companies in the amount of $236,728,978.

The net effect of both of these separate transactions upon each related retail company was to significantly reduce the company's taxable income in the states in which it did business by both the royalty payment and the interest expense charged by the Taxpayers. The Taxpayers did not pay tax to any state on the income received from the related retail companies.

II. TRADEMARK LAW PRINCIPLES

A discussion of trademark law principles is necessary to an understanding and resolution of the issues of this case. Trademarks, tradenames, and service marks are forms of intellectual property that are regulated under the Lanham Act, 15 U.S.C. §§ 1051 *et. seq.*, and recognized and protected under common law. The Lanham Act defines "trademark" to "include any word, name, symbol, or device, or any combination thereof . . . used by a person, or . . . which a person has a bona fide intention to use in commerce and applies to register on the principal register established by the Act, to identify and distinguish his or her goods from those manufactured or sold by others and to indicate the source of the goods." 15 U.S.C. § 1127. The Lanham Act defines "tradename" as "any name used by a person to identify his or her business or vocation." *Id.*

Trademarks are regarded as "property." J. THOMAS MCCARTHY, MCCARTHY ON TRADEMARKS AND UNFAIR COMPETITION, § 18.01[1] (4th Ed. 1998). However, they

enjoy a unique status under the law. The United States Supreme Court has characterized the nature of trademarks as follows:

> There is no such thing as property in a trademark except as a right appurtenant to an established business or trade in connection with which the mark is employed. The law of trademarks is but a part of the broader law of unfair competition; the right to a particular mark grows out of its use, not its mere adoption; its function is simply to designate the goods of a particular trader and to protect his good will against the sale of another's product as his; and it is not the subject of property except in connection with an existing business.

United States Drug Co. v. Theodore Rectanus Co., 248 U.S. 90, 97 (1918).

A trademark "is merely a symbol of goodwill." MCCARTHY, § 17.03[2]. Trademarks and the goodwill of the business with which they are associated are "as inseparable as Siamese Twins who cannot be separated without death to both." *Id.* A trademark "has no independent significance apart from the goodwill it symbolizes." *Id.* "If there is no business and no goodwill, a trademark symbolizes nothing." *Id.*

Another noted trademark law expert notes:

> There is a highly unique legal relationship between trademarks and the goodwill they come to represent. This relationship is fundamental to the law of trademarks, and several important consequences flow from it. First, a trademark may not be assigned apart from the goodwill it symbolizes. Second, a trademark cannot exist

> apart from the going business in which it is used. The trademark and the goodwill it represents can thus be said to be inseparable. Since there can be no goodwill for the trademark to symbolize without such going business and corresponding use of the trademark, trademark rights in the United States, at least, are wholly dependent on actual use.

JEROME GILSON, TRADEMARK PROTECTION AND PRACTICE, Vol. 1, § 1.03[7][b].

Trademarks must continue to be used in connection with an existing business to retain their status as a protected property right. Otherwise, they may be considered abandoned. According to Professor McCarthy, "[i]t is the actual usage of a symbol as a 'trademark' in the sale of goods which creates and builds up rights in a mark. Therefore, lack of actual usage of a symbol as a 'trademark' can result in a loss of legal rights . . . known as 'abandonment.'" MCCARTHY, § 17.03[1].

Because of the inseparability of the trademark and goodwill it symbolizes, a trademark cannot be sold or transferred without the goodwill. An assignment of the mark alone is referred to as a "naked assignment" and is invalid. *Visa U.S.A., Inc. v. Birmingham Trust National Bank*, 696 F.2d 1371 (Fed. Cir. 1982), *cert. denied*, 464 U.S. 826 (1983); *see also* 15 U.S.C. § 1060.

A trademark license is a contractual arrangement whereby a trademark owner permits another to use the owner's trademark under circumstances where, but for the license, the other would be an infringer. GILSON, § 6.01[2]. The moment a trademark owner permits someone else to use its mark, trademark law and overriding public interest

impose a new obligation on the owner with respect to the quality of the goods sold under the trademark. The owner must stringently control the nature and the quality of the goods sold under the mark by the licensee and must at all costs avoid deceiving the public. GILSON, § 6.01[4].

Early trademark decisions generally held that a trademark could not be licensed. *See, e.g., Macmaham Pharmacal Co. v. Denver Chem. Mfg. Co.*, 113 F. 468 (8th Cir. 1901). These cases took the view that a trademark could designate only a single source of goods. GILSON, § 6.01[4]. The "source" theory evolved into the "guarantee of quality" theory over time, however, and the concept of quality control emerged in judicial decisions permitting licensing if certain controls were maintained by the licensor. If the trademark owner exercised adequate control over the nature and quality of the goods sold by the licensee under the mark, the public would not be deceived, but would obtain goods of uniform quality from both sources. GILSON, § 6.01[4].

The concept of quality control was incorporated in the Lanham Act in 1946 by the establishment of the "related company" doctrine. GILSON, § 6.01[4]. Under the Lanham Act, a "related company" is defined as "any person whose use of the mark is controlled by the owner of the mark with respect to the nature and quality of the goods or services on or in connection with which the mark is used." 15 U.S.C. § 1127. The rationale for the "related company" doctrine has been described as follows:

> Without the requirement of control, the right of a trademark owner to license his mark separately from the business in connection with which it has been used would create the danger that products bearing the same trademark might be of diverse

> qualities. . . . Thus, unless the licensor exercises supervision and control over the operations of its licensees the risk that the public will be unwittingly deceived will be increased and this is precisely what the Act is in part designed to prevent. . . . Clearly the only effective way to protect the public where a trademark is used by licensees is to place on the licensor the affirmative duty of policing in a reasonable manner the activities of his licensees.

GILSON, § 6.01[4]. The "related company" doctrine has been described as follows:

> The Lanham Act does not expressly require a trademark licensor to exercise quality control. . . . Instead, it operates through the "related companies" doctrine on a reward-punishment incentive system. If the licensor controls quality adequately, the licensee becomes a "related company" and the licensor obtains the benefits of Section 5. If he does not, and the mark thereby ceases to function as an identification of source, he loses his trademark rights through abandonment.

GILSON, § 6.01[5]. Section 5 of the Lanham Act provides:

> Where a registered mark or a mark sought to be registered is or may be used legitimately by related companies, such use shall inure to the benefit of the registrant or the applicant for registration, and such use shall not affect the validity of such mark or of its registration, provided such mark is not used in such a manner as to deceive the public.

15 U.S.C. § 1055.

According to Gilson, "[t]oday, control over the nature and the quality of the goods or services is the touchstone of a valid trademark license." GILSON, § 6.01[4]. However, "[i]f control is not adequately maintained, the license is a 'bare' or 'naked' license and the trademark owner faces possible abandonment of his trademark rights." GILSON, § 6.01[4]. Under Section 45 of the Lanham Act, the licensor has the duty to exercise control over both the "nature" and the "quality" of the goods sold under the mark by the licensee. GILSON, § 6.01[5]. Regarding the "nature" of the goods sold, the licensor must specify the products with which the licensed marks are to be used. *Id.* If it does not, the marks may be deemed abandoned. *Id.* The trademark owner must also prevent the licensee from using the mark on products other than those the licensor has specified. *Id.* Under this principle, a licensor must prosecute a licensee for trademark infringement if the licensee uses the mark on goods not specified by the licensor. *Id.*

The Act "contemplates *actual control.*" GILSON, § 6.01[5] (emphasis in original). The mere legal right to control is not sufficient. GILSON, § 6.01[5]. Likewise, a voluntary exchange of information is insufficient. *Philip Morris, Inc. v. Imperial Tobacco Co.*, 282 F.Supp. 931 (E.D. Va. 1967), *aff'd*, 401 F.2d 179 (4th Cir. 1968), *cert. denied*, 393 U.S. 1094 (1969).

Furthermore,

> [s]o long as quality control is in fact exercised, there is no legal requirement that the trademark license agreement be in writing or, if it is, that it contain an express provision on the subject. At the same time, mere "paper control," a quality control provision in the licensing agreement without actual control, is insufficient. The crucial

> question is whether the licensor in fact exercises sufficient control to guarantee the quality of the goods or services sold to the public under the trademark.

GILSON, § 6.01[5]. The significance of control cannot be overstated. An uncontrolled or "naked" license constitutes an abandonment of the licensor's rights in the mark. GILSON, § 6.01[6].

The concept of use is also crucial. Actual use of the mark is necessary to retain its status as a protected property right. Absent use, the mark is abandoned. Non-use for two consecutive years is *prima facie* evidence of abandonment. 15 U.S.C. § 1127. Unless the use of the mark by the licensees (the related retail companies in this case) inures to the benefit of the licensors (the Taxpayers in this case), the marks are abandoned. Use by the licensee can only inure to the benefit of the licensor if the licensee is a "related company" under the Lanham Act. In order to be a related company, however, and obtain the concomitant benefits, the licensor must in fact exercise sufficient actual control over the licensee's use of the marks and the nature and quality of the goods sold under the mark.

Thus, under applicable principles of trademark law, unless the Taxpayers exercised actual control, in fact, over the use of the marks by the related retail companies in North Carolina, and the nature and quality of the goods sold under the marks by the related retail companies in North Carolina, the licenses by the Taxpayers to the related retail companies would have constituted "naked" licenses and the Taxpayers' rights in the marks would have been abandoned. If the Taxpayers exercised sufficient control in fact over the related retail companies, however,

the use of the marks by the related retail companies would have inured to the benefit of the Taxpayers and the marks would not have been abandoned.

III. DOING BUSINESS IN NORTH CAROLINA

The Department assessed Taxpayers for corporate income and corporate franchise tax for the three fiscal years ending on January 31, 1992, 1993, and 1994. Taxpayers had not filed a return for those years. The Taxpayers contend that they were not doing business in North Carolina in those tax years and the Department contends that they were.

I find that the Taxpayers were doing business in this State during those years and are therefore subject to this State's corporate income tax and corporate franchise tax. I further find, for reasons discussed below, that the assessments for tax years 1992 and 1993 should nevertheless be canceled. The assessment for tax year 1994 is upheld. At the administrative hearing held on June 11, 1998, I granted Taxpayers' motion to waive all penalties associated with tax year 1994, because, in my opinion, Taxpayers acted reasonably and under advice of counsel in their interpretation of the applicable law.

G.S. 105-130.3 imposes a tax on the State net income of every C corporation doing business in this State. G.S. 105-122 imposes a franchise tax on every corporation incorporated or domesticated under the laws of this State or doing business in this State. The term "doing business" is defined by statute for corporate franchise tax purposes and is defined by administrative rule for corporate income tax purposes. G.S. 105-114(b)(3), which is in the franchise tax laws, defines "doing business" as "[e]ach and every act,

power, or privilege exercised or enjoyed in this State, as an incident to, or by virtue of the powers and privileges granted by the laws of this State." Administrative Rule 17 NCAC 5C .0102 reads, in relevant part, as follows:

.0102 DOING BUSINESS DEFINED

(a) For income tax purposes, the term "doing business" means the operation of any business enterprise or activity in North Carolina for economic gain, including, but not limited to, the following:

* * *

(5) the owning, renting, or operating of business or income producing property in North Carolina including, but not limited to, the following:

(A) Realty;

(B) Tangible personal property;

(C) Trademarks, tradenames, franchise rights, computer programs, copyrights, patented processes, licenses.

The non-exclusive list of examples in subparts (5)(A) through (5)(C) of the rule was added effective November 2, 1992. The remainder of the rule has been in effect since at least 1963. It was first published in the Department's Rules and Bulletins and was incorporated in the North Carolina Administrative Code by the Attorney General's Office in 1976.

The Taxpayers insist that the administrative rule must be given prospective treatment only and cannot apply to the first two fiscal years. They argue that because

the first two fiscal years began prior to the effective date of the 1992 amendment, the rule cannot apply and the assessments for those years must be vacated.

The Department responds that even though the specific example set forth in 17 NCAC 5C .0102(a)(5)(C) was not effective until November 2, 1992, the "doing business" rule was published since at least 1963. Thus, the Secretary's interpretation of G.S. 105-130.3 that the operation of a business activity or enterprise in this State for economic gain constitutes "doing business" for corporate income tax purposes was published well prior to 1992.

The Taxpayers nevertheless argue that the rule did not provide adequate notice that operation of their particular type of business enterprise or activity in this State for economic gain would subject them to tax. Their argument continues that the 1992 amendment of the rule constituted a change in policy and therefore must be given prospective treatment only under G.S. 105-264.

I find that the 1992 amendment to the rule did not constitute a change in policy by the Department. The administrative rule, both prior to and after the 1992 amendment, explicitly stated that the operation of a business activity or enterprise in North Carolina for economic gain, including but not limited to, the owning, renting, or operating of business or income-producing property in North Carolina constitutes "doing business" for corporate income tax purposes.

I further find, however, that the subject of when a corporation is doing business in a state was and continues to be a subject of nationwide debate among states, taxpayers, scholars, jursists, and commentators. Under the specific facts of this case, I find it reasonable to cancel the

assessments for the fiscal years ending January 31, 1992 and 1993, which began prior to the effective date of the 1992 amendment to the rule that added the specific example for trademarks and tradenames.

G.S. 105-264 authorizes the Secretary to adopt administrative rules interpreting all laws she administers and states that an interpretation by the Secretary is *prima facie* correct. Administrative Rule 17 NCAC 5C .0102 was adopted by the Secretary to interpret G.S. 105-130.3, a law she administers, and is therefore *prima facie* correct.

The administrative rule properly does not attempt to set forth an all-inclusive definition of "doing business" for corporate tax purposes. The North Carolina Supreme Court held, in an early franchise tax case, that "[n]o all-embracing rule as to what is 'doing business' has been laid down. The question is one of fact, and must be determined largely according to the facts of each individual case, rather than by the application of fixed, definite, and precise rules." *C.T.H. Corp. v. Maxwell*, 212 N.C. 803, 810, 195 S.E. 36, 40 (1938).

In *C.T.H. Corp.*, the Court noted that the expression "doing business in this State" for purposes of a service of process statute "means engaging in, carrying on, or exercising in this State, some of the things, or some of the functions, for which the corporation was created." *Id.*, 212 N.C. at 811, 195 S.E. at 41. Significantly, the Court then observed that "[a] broader meaning is to be given the words 'doing business' as used in a tax statute." *Id.*

Under Administrative Rule 17 NCAC 5C .0102(a), a taxpayer is considered to be "doing business" in this State if it operates any business enterprise or activity in this State for economic gain, including but not limited to the

owning, renting, or operating of business or income-producing property in North Carolina. The Taxpayers argue that the rule exceeds the scope of the statute because it expands the definition of "doing business" beyond what is permitted by the statue. (Taxpayers' Post Hearing Brief at 36). According to Taxpayers, the Department's interpretation could subject an individual celebrity to tax just because the celebrity receives an economic benefit from royalties on products sold in the state. (*Id.*)

In response, the Department pointed out several significant distinctions between the hypothetical examples raised by Taxpayers and the facts of this case, most notably that the administrative rule does not define "doing business" merely as deriving an economic benefit from the State. Instead, subsection (a) of the rule sets forth the basic premise that "doing business" means the operation of a business activity or enterprise in North Carolina for economic gain. (Department's Post-hearing Brief at 27-28; Department's Responses to Questions at 3).

Although in some isolated circumstances, it may be possible that the rule could conceivably be interpreted in such a manner so as to impose a tax upon an entity that may not be properly taxable as Taxpayers argue, that is not the situation here and those facts are not before me. In this case, the Department has properly applied the applicable statues and administrative rule; the Taxpayers are "doing business" in this State because they are operating a business activity or enterprise in North Carolina for economic gain. There is no "overreaching" under the facts of this case. The Taxpayers' activities fall within the plain language of the rule.

The Taxpayers own valuable intangible property in the form of trademarks, tradenames, and service marks and the goodwill associated with the marks. This property is business or income-producing property. The property is intangible property and, under applicable principles of law, has acquired a business situs where it is used. *See Wheeling Steel Corp. v. Fox*, 298 U.S. 193 (1936). The Taxpayers' property is used in North Carolina. Consequently, Taxpayers own business or income-producing property in North Carolina.

Under trademark law, Taxpayers' property cannot exist apart from an established business in which it is used; if the property is not used, the property is considered abandoned and ceases to exist. The Taxpayers' property therefore exists only where it is used. The Taxpayers' property is used extensively in North Carolina in connection with established businesses. These established businesses are the 130 plus North Carolina retail locations of Taxpayers' related retail companies.

The Taxpayers' marks are permanently affixed to the retail locations and appear on the labels of merchandise sold at the locations. As a result, Taxpayers' marks are used at the retail locations each time employees at the locations sell merchandise. This use, which occurs in North Carolina, preserves the existence of Taxpayers' property.

The Taxpayers rent their intangible property in North Carolina by licensing the use of the property to their related retail companies, which operate over 130 retail locations in North Carolina. The licensing agreements require the related companies to make royalty payments to Taxpayers for the use of Taxpayers' property. The

Taxpayers purposefully license their property for use in this State. The Taxpayers in fact earn significant royalty income from the licensing agreements. The Taxpayers therefore license business or income-producing property in North Carolina.

The Taxpayers operate business or income-producing property in North Carolina through the licensing agreements with their related retail companies. These agreements created a contractual agency relationship between the related retail companies and the Taxpayers.

The related retail companies are affiliates of Taxpayers based on corporate structure and are also related companies of Taxpayers within the "related company" doctrine of the Lanham Act. Under that doctrine, an owner of a trademark that licenses the trademark for use by another must control the nature and quality of the goods and services sold under the trademark and must protect the mark from unauthorized use by others in order for the licensee's use of the trademark to be attributed to the owner, thereby preserving the existence of the trademark.

As licensors, therefore, Taxpayers must exercise actual control in fact over the use of their marks by their licensees and over the quality of goods and services sold under the marks or risk losing the marks. Through this control, the use of the marks in North Carolina by the related retail companies is attributed to and inures to the benefit of each of the Taxpayers, thus protecting the value and preserving the existence of their only assets. Because of this control, the use of the marks in North Carolina by the retail locations of the related retail companies is attributed to and inures to the benefit of Taxpayers.

Accordingly, the Taxpayers exercise control over the marks through the licensing agreements between the Taxpayers and the related retail companies. These agreements required the related retail companies to maintain and protect the standards of quality established by the Taxpayers, to protect and enhance the goodwill associated with the marks, and to ensure proper use of the marks. Pursuant to the licensing agreements, the related retail companies perform activities in this State that fulfill Taxpayers' obligations to control the quality and nature of goods and services sold under Taxpayers' marks and to protect the marks from unauthorized use by others.

Because Taxpayers have no employees, Taxpayers must rely on their related retail companies to provide the required control. The retail locations of the related retail companies affix the marks to their locations, select the merchandise that will bear a label with the marks, inspect the merchandise to ensure that it is of suitable quality to bear the marks, sell merchandise bearing the marks, prepare quarterly inspection reports about activities at the retail locations, establish a store layout and design that is appropriate to bear the marks, and report trademark violations to Taxpayers.

The activities of the related retail companies also result in maintaining and enhancing a market in North Carolina for merchandise bearing Taxpayers' marks. Through these activities, Taxpayers purposefully avail themselves of the benefits of an economic market in North Carolina. Taxpayers' primary source of income, the royalties, was dependent upon the activities conducted by employees at the 130 North Carolina retail locations.

In summary, Taxpayers are doing business in North Carolina because they are operating a business enterprise or activity in North Carolina for economic gain. The Taxpayers' activities fall within all three of the possible methods set out in Administrative Rule 17 NCAC 5C .0102(a)(5) by which an entity could be doing business in this State. If the Taxpayers' activities fit any one of these methods, the Taxpayers would be doing business in North Carolina. The Taxpayers own business or income-producing property in North Carolina, the Taxpayers license business or income-producing property in North Carolina, and the Taxpayers operate business or income-producing property in North Carolina.

IV. EXCLUDED CORPORATIONS

Because it has been determined that the Taxpayers are properly subject to the corporate income and franchise tax, a determination must be made as to whether they are "excluded corporations" as defined in G.S. 105-130.4(a)(4). If the Taxpayers are "excluded corporations," G.S. 105-130.4(r) requires that their business income be apportioned by multiplying the income by the sales factor as determined under G.S. 105-130.4(l). If the Taxpayers are not excluded corporations, a different method of apportionment applies under G.S. 105-130.4(i) based on property, payroll, and sales. The relevant portion of G.S. 105-130.4(a)(4) defines an "excluded corporation" as "a corporation which receives more than fifty percent (50%) of its ordinary gross income from investments in and/or dealing in intangible property."

The Taxpayers contend that the phrase "investments in" intangibles as used in the statute does not include

Taxpayers' activities of protecting, managing, and maintaining trademarks. The Taxpayers further contend that because they do not buy and sell their intangible property for the purpose of gain in the market, they do not "deal" in intangible property. They argue that their activities are not the same as "investments in and/or dealing in" intangibles, and they cite an Opinion of the North Carolina Attorney General, [1954-1994 Transfer Binder] N.C. St. Tax Rep. (CCH) par. 201-528 (Aug. 18, 1976), in support of that position.

According to Taxpayers, the Attorney General's opinion states that an entity will not be deemed to be dealing in intangible property unless it engages in "buying and selling [intangible property] for the purpose of gain in the market." *Id.* Their argument continues that because they did not buy and sell the trademarks for the purpose of gain in the market, they did not "deal in" intangible property and cannot therefore be considered "excluded corporations." (Taxpayers' Post-Hearing Answer Brief at 31).

The Department responds that Taxpayers have investments in intangible property and that Taxpayers deal in intangible property. According to the Department, an entity makes an investment in property when it acquires the property for the purpose of making a profit. The Department therefore maintains that Taxpayers' acquisition of the marks and goodwill constituted an investment by Taxpayers in intangible property.

Although the Taxpayers insist that they are engaged in the business of owning, managing, and protecting the trademarks they acquired, it is only logical that they must have also acquired these intangible assets to generate a

profit. In fact, the acquisition of the trademarks and their subsequent licensing to the related retail companies did result in significant profits to the Taxpayers. It is reasonable to assume that when a corporation obtains an asset, it is doing so as an investment with the ultimate purpose of increasing profits by generating revenues or reducing expenses.

The Department argues that the ordinary meaning of the phrase "dealing in" is broader than simply "buying and selling" and includes licensing. The Department asserts that Taxpayers' activities in acquiring their intangible property and subsequently licensing the property to their related retail companies in exchange for royalty payments constitutes dealing in intangible property.

I agree with the Department's position. In my opinion, the Taxpayers both "invest" and "deal" in the trademarks, which are intangible property. The Taxpayers received more than 50% of their ordinary gross income from their investments in or dealing in the trademarks. They therefore meet the statutory definition of "excluded corporation" set forth in G.S. 105-130.4(a)(4).

Because the Taxpayers are "excluded corporations," G.S. 105-130.4(r) specifically requires that they apportion their business income using the sales factor as determined under G.S. 105-130.4 (l). The Taxpayers argue that the single-factor sales formula based upon the sales receipts of the related retail companies does not account for those trademark management and protection activities of the Taxpayers that occur outside of North Carolina. (Taxpayers' Post-Hearing Brief at 67). Therefore, the argument continues, an unfair apportionment of tax results because the "state has applied a method, which . . . operates so as

to reach profits which are in no just sense attributable to transactions that occurred in North Carolina." *Hans Ress' Sons v. North Carolina ex rel. Maxwell*, 283 U.S. 123, 134 (1931).

The Department responds, correctly in my opinion, that the royalty income earned by the Taxpayers arises directly from the use of the trademarks in North Carolina by the related retail companies pursuant to the licensing agreements. While some trademark management activities may have occurred outside of this State, it was the use of the trademarks by the North Carolina retailers that generated the retail sales of apparel bearing these trademarks and resulted in the royalty income to Taxpayers. Thus, the principal income-producing activity of the Taxpayers consisted of their licensing of the trademarks and the resulting royalty income from the use of the trademarks in this State and in other states. The apportionment of the royalty income based upon the relationship of gross retail sales from North Carolina retail locations that were licensed to use Taxpayers' intangible property to gross retail sales of all locations licensed to use Taxpayers' intangible property is an equitable and meaningful method of computing the taxable income of the Taxpayers.

G.S. 105-130.4(t)(4) precludes the use by the Taxpayers of any alternative formula to the sales factor without a written order from the Tax Review Board. As there is no such order, the Taxpayers are required to use the prescribed sales factor. G.S. 105-130.4(l)(3) provides that sales occur in this state if "[t]he receipts are from intangible property and are received from sources with this State." Furthermore, "[t]here shall be a presumption that the appropriate allocation formula reasonably attributes to

this State the portion of the corporation's income earned in this State, and the burden shall rest upon the corporation to show the contrary." G.S. 105-130.4(t)(4). The appropriate forum for the relief sought by the Taxpayers is the Tax Review Board. The Taxpayers have not sought this relief. Therefore, the Taxpayers must use the single-factor sales formula prescribed in G.S. 105-130.4(r) to apportion their business income.

V. CONSTITUTIONAL ISSUES

Both sides have spent considerable time developing excellent, detailed, and exhaustive constitutional analyses in support of their respective positions regarding the issue of whether the Taxpayers have taxable nexus with North Carolina. Although it is well settled that the Secretary cannot rule on the constitutionality of a statute, the matter certainly warrants comment. *Great American Insurance Company v. Gold*, 254 N.C. 168 (1961). Predictably, the arguments center around the differing interpretations of the United States Supreme Court decisions in *National Bellas Hess, Inc. v. Department of Revenue of Ill.*, 386 U.S. 753 (1967), *Complete Auto Transit, Inc. v. Brady*, 430 U.S. 274 (1977), and *Quill Corp. v. North Dakota*, 504 U.S. 298 (1992), as well as the sometimes celebrated, sometimes criticized decision by the South Carolina Supreme Court in *Geoffrey, Inc. v. South Carolina Tax Commission*, 437 S.E.2d 13, *cert. denied*, 510 U.S. 992 (1993).

A. Due Process

It has been established that the nexus requirements of the Due Process Clause and Commerce Clause of the

U.S. Constitution are separate and distinct. *Quill*, 504 U.S. at 305-06, 312. The Department argues that the Taxpayers operate a business activity in North Carolina for economic gain because they extensively use their intangible property in this State through licensing agreements with their related retail companies, the related retail companies perform activities in this State on Taxpayers' behalf that are attributed to Taxpayers, and Taxpayers exercise actual control in fact over the use of the marks by the related retail companies in this State. The Department asserts that this business activity creates sufficient nexus with this State to permit the assessment of corporate income and franchise tax against the Taxpayers under the Due Process Clause of the U.S. Constitution.

The two requirements that must be met to satisfy the Due Process Clause are: (1) some minimal connection between the interstate activities and the state seeking to impose the tax; and (2) some rational relationship between the income the state is attempting to tax and the intrastate values of the enterprise. *Mobil Oil Corp. v. Commissioner of Taxes*, 445 U.S. 425, 436-437 (1980). Although Taxpayers may have a physical presence in this State, a physical presence is not needed to satisfy the Due Process Clause. If a foreign corporation purposefully derives an economic benefit from a state, then it may be subjected to the jurisdiction of that state without having a physical presence there. *Quill*, 504 U.S. at 307.

The Department asserts that the Taxpayers purposefully derive an economic benefit from North Carolina through the licensing agreements between them and their related retail companies. The Taxpayers controlled the decision whether, to whom, and where they would license

their marks. They purposefully chose to license their marks to 130 North Carolina retail locations. The Department cites these facts along with others as evidence of Taxpayers' intent to participate in the North Carolina marketplace. (Department's Initial Brief at 19). The Department contends that Taxpayers' activities and those of the related retail companies acting on Taxpayers' behalf under the licensing agreements clearly meet the minimum contact requirements of the Due Process Clause.

The Department cites *Geoffrey* and *In the Matter of Kmart Properties, Inc.* CCH ¶ 400-976, New Mexico Revenue and Taxation Department, No. 00-04 (Feb. 1, 2000), as support for its contention that the Taxpayers purposefully availed themselves of the economic marketplace in North Carolina, noting that Taxpayers earned significant royalty income from garment sales generated by the North Carolina retail locations of the related retail companies. In *Kmart*, the court held that the trademark holding company subsidiary, which had no employees and no tangible or real property in New Mexico, had sufficient minimum contacts because it purposefully availed itself of the benefits of New Mexico's economic market by licensing highly valuable intangible property for use in New Mexico retail stores in return for royalty income.

The Taxpayers respond that the Due Process Clause "requires some definite link, some minimum connection, between a state and the person, property or transaction it seeks to tax." *Miller Bros. v. Maryland*, 347 U.S. 340, 344-45 (1954). They argue that there is no definite link or minimum connection between any of Taxpayers and North Carolina and that none of the Taxpayers purposefully directed any of their activities toward residents of this State as required to establish nexus for purposes of the

Due Process Clause under *Quill*. Therefore, the Taxpayers conclude, the assessments violate the Due Process Clause. (Taxpayer's Post-Hearing Brief at 41 n.14).

The distinction that the Taxpayers attempt to make between marketing activities directed at the residents of a state as opposed to the market of a state in an attempt to show that the assessments violate the Due Process Clause is not valid. It does appear from the record that the Taxpayers purposefully directed their business activities toward the North Carolina market as well as the residents of this State and derived an economic benefit from those activities that is sufficient to satisfy the minimum contact standards of the Due Process Clause. *Burger King Corp. v. Rudzewicz*, 471 U.S. 462 (1985).

B. Commerce Clause

The Taxpayers also argue that the Department's attempt to subject the Taxpayers to North Carolina corporate income and franchise tax is not permissible under the Commerce Clause of the U.S. Constitution. Their argument is primarily based upon the contention that they do not have a physical presence in North Carolina and therefore cannot be taxable in this State. The Taxpayers insist that in *Quill*, the Supreme Court refined the four-part test set forth in *Complete Auto* to require a physical presence as a minimum criteria to satisfy the substantial nexus portion of the test. Taxpayers further argue that the Department's assessments violate all four parts of that test. (Taxpayers' Post Hearing Brief at 40-58).

According to the Taxpayers' argument, the Taxpayers have no physical presence in this State. The Taxpayers' argument continues that, because the U.S. Supreme Court

in *Quill* held that an out-of-state retailer with no physical presence in the state could not be required to collect use tax on its sales to in-state customers, the Taxpayers cannot be required to pay corporate income and franchise tax here. The Taxpayers argue that the physical presence requirement articulated in *Quill* for establishing substantial nexus is not limited to sales and use taxes but is also applicable to North Carolina's corporate income and franchise tax. (Taxpayers' Post-Hearing Brief at 43).

The Department responds that the Taxpayers are doing business in North Carolina as defined in Administrative Rule 17 NCAC 5C. 0102 for the reasons previously stated. The Department takes the position that the assessments do not violate the Commerce Clause for two primary reasons. First, the test under the Commerce Clause is substantial nexus rather than physical presence and Taxpayers have substantial nexus with North Carolina. Second, even if physical presence were required, the activities of the related retail companies performed in North Carolina on the Taxpayers' behalf pursuant to the companies' contractual agency relationship with the Taxpayers, as well as other factors, satisfy the physical presence requirement. The Department further contends that the assessments in this case do not run afoul of *Complete Auto's* other three requirements.

Under the *Complete Auto* four-prong test, a tax satisfies the Commerce Clause if it meets all of the following criteria:

(1) It is applied to an activity with a substantial nexus with the taxing state.

(2) It is fairly apportioned.

(3) It does not discriminate against interstate commerce.

(4) It is fairly related to the benefits and services provided by the state.

The Department's interpretation of *Quill* is understandably different from that of Taxpayers' counsel in that it states that substantial nexus, not physical presence, is required to meet the requirements of the Commerce Clause. The Department argues that the Supreme Court in *Quill* reaffirmed the physical presence requirement established in *Bellas Hess* for sales and use taxes, but did not extend the requirement to corporate income taxes. According to the Department, the Taxpayers have substantial nexus with North Carolina because they extensively use their intangible property in this State through licensing agreements with their related retail companies, the related retail companies perform activities in this State on Taxpayers' behalf that are attributed to and inure to the benefit of Taxpayers, and Taxpayers exercise actual control in fact over the use of the marks by the related retail companies in this State.

The Department points to the following in support of its contention:

(1) The Taxpayers' trademark licensing activities.

(2) The Taxpayers' purposeful availment of the marketplace here.

(3) The business situs of the Taxpayers' trademarks in this State.

(4) The representatives of the Taxpayers that perform services in this State on Taxpayers' behalf. (Department's Initial Brief at 21).

For these reasons, concludes the Department, the substantial nexus prong of the *Complete Auto* test and the requirements of the Commerce Clause are satisfied and Taxpayers have taxable nexus here. (Department's Initial Brief at 21-22).

In support of its argument that the Taxpayers' trademark licensing activities in North Carolina are sufficient to meet the substantial nexus requirement, the Department cites the holding of the Supreme Court of South Carolina in *Geoffrey*. (Department's Initial Brief at 22). That case also involved a trademark protection company domiciled in Delaware that licensed the use of a trademark to an affiliated retailer located in South Carolina. The court held that the licensing of intangibles and the deriving of income from their use by an out-of-state corporation created substantial nexus with South Carolina.

The Department also cites the decision of *Kmart Properties, Inc.* That case also involved the formation of a separate trademark holding company to own and license trademarks and tradenames to an affiliated retail company, the original owner of the trademarks, for use in the retail operations in the exact same manner in which they had been previously used. *Kmart* held that a wholly-owned subsidiary that licensed trademarks to an affiliated operating store had substantial nexus with the state sufficient to satisfy the Commerce Clause.

In *Kmart*, the court held that the license agreement, which required the parent corporation to establish, maintain, and enhance the market for the subsidiary's trademarks in

New Mexico, created a contractual agency relationship between the parties that provided the substantial nexus needed between the in-state parent company and the out-of-state subsidiary under the Commerce Clause of the U.S. Constitution.

The Department also argues that the Taxpayers have substantial nexus with North Carolina because their trademarks have a business situs here. (Department's Initial Brief at 28-31). The Department states that the use of the trademarks by the Taxpayers in furtherance of their licensing activities in this State gives the trademarks a business situs in North Carolina. Citing the requirements of trademark law and the Lanham Act that a mark must be used in connection with an existing business in order to prevent its abandonment, the Department avers that the Taxpayers must be considered as having used the trademarks here because the usage in North Carolina by the related retail companies inures to the benefit of the Taxpayers and therefore protects and preserves the value and existence of the marks. The Department states that "[u]se of the trademark occurs every time a garment is sold to a North Carolina consumer." (Department's Post Hearing Brief at 16).

The Department contends that the fact that the Taxpayers have no employees or offices in North Carolina is not fatal to its assessments of corporate income and franchise tax because business activities were performed here by the related retail companies on behalf of the Taxpayers in furtherance of the companies' attempts to generate income here. *Tyler Pipe Industries, Inc. v. Washington Department of Revenue*, 483 U.S. 232 (1987). The Department argues that the quality assurance and other activities performed by the employees of the related retail

companies as required by the trademark licensing agreements and necessary for the protection of the marks should be attributed to the Taxpayers because these activities are necessary to preserve the existence of Taxpayers' marks, the activities are performed to fulfill Taxpayers' obligations under trademark law, and the activities helped maintain Taxpayers' market in North Carolina. Therefore, under the analysis in *Tyler Pipe*, substantial nexus exists between the Taxpayers and this State.

The Department also cites *Scripto, Inc. v. Carson*, 362 U.S. 207 (1960), in support of its argument that the trademark quality control measures and other activities performed by the employees of the related retail companies should be construed as being done by Taxpayers. In *Scripto*, taxable nexus was established when an out-of-state retailer engaged independent contractors to conduct activities on its behalf within the taxing state. According to the Department, the quality control activities were required for the protection of the trademarks and to enhance the North Carolina market for the Taxpayers, allowing them to generate significant royalty income arising from the retail sales here. Because these activities were performed in North Carolina by the related retail companies' employees under their contractual agency relationship with the Taxpayers, the activities should be attributed to the Taxpayers. It is "these trademark protection activities performed in this State that create the substantial nexus [and] that justify subjecting the Taxpayers to tax." (Department's Initial Brief at 35).

The Taxpayers respond that the contractual relationship that existed between Taxpayers and the related retail companies in North Carolina is not enough to meet the

substantial nexus standard. They argue that the activities of the related retail companies' employees, although performed to comply with the required terms of the trademark licensing agreements, should not be attributed to the Taxpayers. The Taxpayers contend that the employees of the related retail companies were neither independent contractors nor agents for the Taxpayers when they performed the activities and these activities did not directly establish a market for in-state sales by the Taxpayers, which distinguishes them from the taxpayers in both *Tyler Pipe* and *Scripto*. (Taxpayers' Post-Hearing Answer Brief at 28). The Taxpayers argued that since they have no employees, the activities of the employees of its in-state affiliates cannot be attributed to them.

The *Scripto* Court has already rejected the Taxpayers' argument by ruling that the distinctions between independent contractors and employees are without constitutional significance. It is of no consequence whether the activities are performed by a taxpayer's own employees (of which the Taxpayers had none in this case) or by others acting on the taxpayer's behalf. Here, the activities performed by the employees of the related retail companies are properly attributable to the Taxpayers.

Professor Richard Pomp, Taxpayers' expert witness, confirms this fundamental principle:

> Of course, employees are only one category of individuals operating on behalf of a corporation who can provide the corporation with physical presence in the state. The in-state actions of agents and independent contractors can also confer nexus. While the relevant case law does not establish all of the relevant boundary lines, it is clear that an independent contractor does not

> have to work exclusively for the out-of-state corporation to confer nexus.

Richard D. Pomp and Oliver Oldman, State & Local Taxation, Vol. II, 9-94 (3rd. ed. 1998), (citing *Scripto*, 362 U.S. 207). (See also T3 p. 156).

In addition to the legal arguments arising from their interpretation of the nexus requirements of *Quill*, the Taxpayers presented testimony and various exhibits containing detailed economic analyses from several experts in the field of economics who opined why physical presence should be a required element of taxable nexus for North Carolina state taxation purposes under broadly accepted concepts of economic theory. Although the reports and testimony of the various expert witnesses offered by the Taxpayers may or may not have been admissible under the North Carolina Rules of Evidence, *see* G.S. § 8C-1, Rules 701, 702, and 704, or otherwise competent, the rules of evidence do not apply at an administrative hearing before the Secretary. According to Taxpayers' expert witnesses in economics, the reasons why physical presence should determine taxable nexus for North Carolina state tax purposes include: (1) preventing the improper exportation of tax burden; (2) ensuring proper matching of the cost of a state's benefits to the users of the state's services; and (3) preventing confusion in compliance. (Taxpayers' Post-Hearing Brief at 49-51).

The Taxpayers also cite many tax policy reasons for utilizing a bright-line rule in establishing a nexus standard for Commerce Clause analysis and why a physical presence test is so advantageous for that purpose. (Taxpayers' Post-Hearing Brief at 52-55). The Taxpayers' expert witness in tax policy, Professor Richard Pomp,

testified that the use of the physical presence test prevents ambiguity, avoids the risk of multiple taxation, allows settled expectations, helps maintain parity in the taxation of service companies with other industries and avoids practical complications in the administration of a tax.

In Secretary's Final Decision 98-299, I stated that a physical presence is not required to establish taxable nexus for purposes of imposing corporate income taxes, although the taxpayer in that case did have a physical presence in North Carolina through its ownership of tangible personal property here. The Taxpayers understandably disagree with that decision. However, I continue to believe, in spite of the reasons given by the Taxpayers' expert witnesses discussed above, that the evolution of present day commerce requires a more flexible, modern rule that balances the proper jurisdiction of states to tax against the legitimate concerns of imposing inappropriate barriers to interstate commerce. (Taxpayers' Letter to the Assistant Secretary dated April 12, 2000, at 9 n.2).

Indeed, the landscape of commerce has changed significantly just since the inception of this case with the exploding popularity of the use of the internet in business transactions and the attendant problems of developing a proper standard to apply in determining jurisdiction to tax these transactions. While the use of the physical presence standard may very well appeal to Taxpayers' expert witnesses, I still believe there is another, better test for determining substantial nexus that recognizes the realities and necessities of today's business climate as well as the various states' fiscal requirements. "The physical presence rule of State taxing jurisdiction is as obsolete as the horse and buggy as we near the twenty-first century's

electronic era." Hellerstein and Hellerstein, State Taxation, par. 6.09, 6-22 (2d ed. 1993) The fact is, we are already there.

VI COMBINED REPORTING

The Department asserts that, as an alternative to filing separate returns, the Taxpayers could be required to file a combined return with the appropriate related retail companies because the returns of the related retail companies do not disclose the true earnings of the companies from their business in this State. According to the Department, this failure is attributable to essentially arbitrary, intercompany transactions.

G.S. 105-130.6 permits the Secretary of Revenue to require a corporation to file a consolidated tax return with its subsidiaries and affiliates if she finds that the return filed "does not disclose the true earnings of the corporation on its business carried on in this State." In addition, G.S. 105-130.16 states, in relevant part, that:

> [w]hen the Secretary has reason to believe that any corporation so conducts its trade or business in such manner as to either directly or indirectly distort its true net income and the net income properly attributable to the State . . . the Secretary may require any facts as the Secretary considers necessary for the proper computation of the entire net income and the net income properly attributable to the State.

It is the Department's contention that the "Taxpayers were involved in an elaborate series of accounting mechanisms designed to shift income among related parties for the

purpose of avoiding state income taxes." (Department's Initial Brief at 44).

The Taxpayers respond that because the royalty rate they charged to the related retail companies was considered "arms length" under the standard set forth in I.R.C. § 482 according to expert witness Dr. Irving Plotkin, then no distortion of income occurred and the requirement of a combined report would be inappropriate. (Taxpayers' Post-Hearing Answer Brief at 30). They insist that the Taxpayers served significant business purposes and the royalty fees incurred by the related retail companies were legitimate deductions.

However, regarding the intercompany agreements between the Taxpayers and the related retail companies, Dr. Irving Plotkin, Taxpayers' expert witness, testified that "[w]hen you deal with a transaction between a related party, the transaction itself is not at arm's length. It cannot be – it could not have come about by an arm's length negotiation." (T. 5/11/98 pp. 68-69). Dr. Plotkin also stated that "[t]he [intercompany] agreement should never have been described as an arm's length agreement, because it couldn't have been." (T. 5/11/98 p. 70).

Dr. Plotkin further testified that the Internal Revenue Service would have had no "motivation" to make an I.R.C. § 482 adjustment to the intercompany transactions because they were completely eliminated in a consolidated federal income tax filing. (T. 5/11/98 p. 92). Dr. Plotkin described I.R.C. § 482 as "the Internal Revenue Code section which gives the Secretary of Treasury the power to adjust transactions that occur between related parties so as to properly reflect income." (T. 5/11/98 p. 41).

The Department takes the position that the related retail companies, by transferring their trademarks to Taxpayers for little or no consideration, then licensing the trademarks they formerly owned back from the Taxpayers, who then recorded the payment of the required royalty fees in accounts receivable and never converted them into cash, shifted millions of dollars of income to Delaware that would normally have been taxable in North Carolina. According to the Department, the royalty fee expenses were merely paper transactions that improperly reduced the North Carolina taxable income of the related retail companies. (Department's Initial Brief at 47).

I agree that the manner in which the Taxpayers conducted their transactions with the related retail companies results in the failure of the related retail companies to accurately disclose their true taxable income from business activities conducted in North Carolina. As an example of the improper reflection or distortion of income that occurred, the Department notes, for example, that Limco's (one of the Taxpayers) total expenses for the three years at issue were $729,175 compared to total accrued income of $311,952,574 during the same period. (Exhibit 72). Of Limco's total expenses, legal expenses alone equaled $687,754 or 94.32% of total expenses. The remaining expenses, such as general, administrative, and other operating expenses, were immaterial and reflect that no substantive operations were actually conducted within the company. (Department's Initial Brief at 10-11).

During the same period, Limco's related retail company, the Limited, reduced its North Carolina apportionable income by millions of dollars in royalty fees – royalty fees paid for the use of trademarks they previously owned and used without the need to pay for such use and which

they transferred to Limco for little or no consideration. The same corporate structure and series of transactions were used for all of the Taxpayers and their related retail companies. The Department's Exhibit 72 shows that during the audit period, the Taxpayers reported $1.2 billion in net income, while the related retail companies reported a net taxable loss of $203 million. But for the royalty fees incurred for the use of trademarks they had previously owned and gave away for little or no consideration, the related retail companies would have been profitable. In my judgment, requiring a combination of the Taxpayers' net income with that of their related retail companies would permit "the underlying substance of the business activities occurring in this State to take precedent over the superficial form of the transactions." (Department's Initial Brief at 47).

Although the Taxpayers insist that the trademarks originally owned and used by the related retail companies were transferred to them for legitimate business reasons other than tax avoidance, the fact remains that the profitability of the related retail companies decreased precipitously immediately subsequent to the trademark transfers. This was an adverse impact on the profitability of the related retail companies that was disproportionately larger than the alleged benefits from the transfers cited by the Taxpayers. Indeed, in view of the tremendous and ongoing negative effect on the net income of the related retail companies resulting from the trademark transfers, one is left to wonder whether a proper analysis of the financial and legal effects of the transactions took place and how the management of the companies could justify the original transfers, let alone the continuation of such an unprofitable arrangement. In my judgment, the transactions

entered into between the Taxpayers and their related retail companies arbitrarily shifted income between them, thereby improperly reflecting their true net income and providing a basis to require the filing of a combined return pursuant to G.S. 105-130.6 and 105-130.16.

The facts of this case support a combination of the Taxpayers and their related retail companies. The facts also support the assessment of Taxpayers for failing to file returns while doing business in this State. In similar cases, the Department could pursue a combination, a separate assessment, or both as alternatives.

VII. CONCLUSION

The cacophony of controversy arising from the widely divergent interpretations of similarly worded statutes and regulations in other states across the nation indicates that the issue of what constitutes substantial nexus is not settled. Indeed, this aspect of tax law has been the subject of many and different opinions in various writings from some of the country's foremost legal scholars and jurists.

Ultimately, many of the outstanding questions concerning when a corporation can be subject to tax in a state must be settled by the United States Supreme Court, which will hopefully address the matter soon. Until then, administrative decisions may only contribute to, rather than dispel, the thick legal mist that surrounds these issues.

While I do not agree with the finding in *Cerro Copper Products, Inc.*, 1995 Ala. Tax Lexis 211 (Ala. Dept. of Rev., Docket Number F-94-444, Dec. 11, 1995) that physical presence is required for nexus, I do concur with Judge

Thompson's statement in that case that the holding in *Geoffrey* may have resulted from the South Carolina Supreme Court's concern "that an out-of-state corporation can economically exploit and profit from a state's citizens, yet cannot be required by the state to pay its fair share of tax." *Id.* at 8. There are clearly some significant and justifiable tax policy reasons to impose corporate income and franchise taxes upon the out-of-state subsidiaries or affiliates of North Carolina companies that license back trademarks acquired in tax-free stock exchanges from those companies with the result that millions of dollars of income are excluded from taxation in this State through various corporate gyrations. *See, e.g.*, I.R.C. § 369(d).

Despite any policy reasons for or against imposing a tax in various circumstances, a Secretary's decision must be based on the applicable law. Under North Carolina's statutes and rules, the Taxpayers are doing business in this State and are excluded corporations.

Therefore, the proposed assessments of corporate income and franchise tax for the fiscal year ended January 31, 1994, as modified herein, are correct under the law and the facts, are sustained, and are immediately due and collectible together with interest as required by law.

This the 19th day of September, 2000.

/s/ Michael A. Hannah
Michael A. Hannah
Assistant Secretary of Revenue

APPENDIX E

No. 23P05 TENTH DISTRICT

SUPREME COURT OF NORTH CAROLINA

****

(A&F Trademark v Tolson)

A&F TRADEMARK, INC.; CACIQUECO, INC.; EXPRESSCO, INC.; LANCO, INC.; LERNCO, INC.; LIMCO INVESTMENTS, INC.; LIMTOO, INC.; STRUCTURECO, INC.; and V. SECRET STORES, INC.

v

E. NORRIS TOLSON, Secretary of Revenue, State of North Carolina, and his successors

From NC Court of Appeals
(COA03-1203)
From Wake
(02CVS7467)

****

ORDER

Upon consideration of the notice of appeal from the North Carolina Court of Appeals, filed by the Petitioners (A&F Trademark, et al) on the 11th day of January 2005 in this matter pursuant to G.S. 7A-30, and the motion to dismiss the appeal for lack of substantial constitutional question filed by the Respondent (Secretary of Revenue), the following order was entered and is hereby certified to the North Carolina Court of Appeals: the motion to dismiss the appeal is

"Allowed by order of the Court in conference, this the 3rd day of March 2005.

s/ Newby, J.
For the Court"

Upon consideration of the petition filed on the 11th day of January 2005 by Petitioners (A&F Trademark, et al) in this matter for discretionary review of the decision of the North Carolina Court of Appeals pursuant to G.S. 7A-31, the following order was entered and is hereby certified to the North Carolina Court of Appeals:

"Denied by order of the Court in conference, this the 3rd day of March 2005.

s/ Newby, J.
For the Court"

WITNESS my hand and the seal of the Supreme Court of North Carolina, this the 7th day of March 2005.

Christie Speir Cameron
Clerk, Supreme Court of North Carolina

/s/ Shaula A. Brannan
Shaula A. Brannan
Assistant Clerk

[SEAL]

Copy to:
North Carolina Court of Appeals
Mr. Ralph A. White, Appellate Reporter (By E-Mail)
Mr. Burley B. Mitchell, Jr., Attorney at Law, For A&F Trademark, et al
Mr. Sean E. Andrussier, Attorney at Law, for A&F Trademark, et al
Mr. Paul H. Frankel, Attorney at Law, For A&F Trademark, et al
Mr. Hollis L. Hyans, Attorney at Law, for A&F Trademark, et al
Ms. Amy F. Nogid, Attorney at Law, for A&F Trademark, et al

Ms. Kay Lynn Miller Hobart, Assistant Attorney General,
For State of NC
Mr. George M. Teague, Attorney at Law, For NCMA, et al
West Publishing Company (By E-mail)
Lexis-Nexis (By E-mail)
LOIS Law (By E-mail)

APPENDIX F

No. COA03-1203 TENTH DISTRICT

North Carolina Court of Appeals

****

A&F TRADEMARK, INC.; CACIQUECO, INC.; EXPRESSCO, INC.; LANCO, INC.; LERNCO, INC.; LIMCO INVESTMENTS, INC.; LIMTOO, INC.; STRUCTURECO, INC.; and V. SECRET STORES, INC., Petitioners, V E. NORRIS TOLSON, Secretary of Revenue, State of North Carolina, and his succesors, Respondents.	From Wake (02CVS7467)

ORDER

The Motion to Dismiss the Appeal for lack of substantial constitutional is Allowed and Petition for Discretionary Review to review the decision of the North Carolina Court of Appeals filed on the 7th day of December 2004 was denied by order of the North Carolina Supreme Court on the 3rd day of March 2005, and same has been certified to the North Carolina Court of Appeals;

IT IS THEREFORE CERTIFIED to the Clerk of Superior Court Wake County North Carolina that the North Carolina Supreme Court has allowed the Motion to

Dismiss the Appeal for lack of substantial constitutional question filed by the Respondent (Secretary of Revenue) and denied the Petition for Discretionary Review filed by the Petitioners (A&F Trademark, et al) in this cause.

WITNESS my hand and official seal this the 17th day of March 2005.

/s/ John H. Connell
John H. Connell
Clerk, North Carolina
Court of Appeals

/s/ Kathy Taylor
Deputy Clerk, North Carolina
Court of Appeals

Orig. to CSC
Copy to:
Mr. Jasper L. Cummings, Jr., Attorney at Law, For A&F Trademark, Inc., et al.
Mr. Paul H. Frankel, Attorney at Law, For A&F Trademark, Inc., et al.
Mr. Hollis L. Hyans
Mr. Craig B. Fields
Ms. Amy F. Nogid
Ms. Kay Linn Miller Hobart, Assistant Attorney General, For E. Norris Tolson
Hon. Burley B. Mitchell, Jr, Attorney at Law, For A & F Trademark
Mr. Sean E. Andrussier
Mr. George M. Teague, Attorney at Law
N.C. Dept of Justice

APPENDIX G

Relevant North Carolina Statutes and Regulation Involved in Effect in 1994

GENERAL STATUTES OF NORTH CAROLINA, 1943, CHAPTER 105 TAXATION, SUBCHAPTER 1 LEVY OF TAXES, Article 4 Division I Corporation Income Tax (As added by Ch. 1110, Laws 1967, applicable to all taxable years beginning on or after January 1, 1967.).

Sec. 105-130.3. Corporations. –

A tax is imposed on the State net income of every C Corporation doing business in this State at seven and seventy-five one-hundredths percent (7.75%) of the corporation's State net income. An S Corporation is not subject to the tax levied in this section.

GENERAL STATUTES OF NORTH CAROLINA, 1943, CHAPTER 105 TAXATION, SUBCHAPTER 1 LEVY OF TAXES, Article 3 Schedule C Franchise Tax.

Sec. 105-114. Nature of taxes; definitions. –

(a) *Nature of taxes.* – The taxes levied in this article upon persons and partnerships are for the privilege of engaging in business or doing the act named. The taxes levied in this article upon corporations are privilege or excise taxes levied upon:

(1) Corporations organized under the laws of this State for the existence of the corporate rights and privileges granted by their charters, and the enjoyment, under the protection of the laws of this State, of the powers, rights,

privileges and immunities derived from the State by the form of such existence; and

(2) Corporations not organized under the laws of this State for doing business in this State and for the benefit and protection which such corporations receive from the government and laws of this State in doing business in this State.

If the corporation is organized under the laws of this State, the payment of the taxes levied by this Article shall be a condition precedent to the right to continue in such form of organization; and if the corporation is not organized under the laws of this State, payment of these taxes shall be a condition precedent to the right to continue to engage in doing business in this State. The taxes levied in this Article or schedule shall be for the fiscal year of the State in which the taxes become due; except that the taxes levied in G.S. 105-122 shall be for the income year of the corporation in which the taxes become due.

G.S. 105-122 does not apply to street transportation systems taxed under G.S. 105-120.1 or holding companies taxed under G.S. 105-120.2. G.S. 105-122 applies to a corporation taxed under another section of this Article only to the extent the taxes levied on the corporation in G.S. 105-122 exceed the taxes levied on the corporation in other sections of this Article.

(b) *Definitions.* – The following definitions apply in this Article:

(1) *Code.* – Defined in G.S. 105-228.90.

(2) *Corporation.* – A domestic corporation, a foreign corporation, an electric membership corporation organized under Chapter 117 of the General Statutes or doing business in this State, or an association that is organized for pecuniary gain, has capital stock represented by shares, whether with or without par value, and has privileges not possessed by individuals or partnerships. The term does not include a limited liability company.

(3) *Doing business.* – Each and every act, power, or privilege exercised or enjoyed in this State, as an incident to, or by virtue of the powers and privileges granted by the laws of this State.

(4) *Income year.* – Defined in G.S. 105-130.2(5).

North Carolina Regulation, **Section .0100. – Corporations Subject to the Tax: Tax Rate and Allocation .0102 Doing Business Defined.–**

(a) For income tax purposes, the term "doing business" means the operation of any business enterprise or activity in North Carolina for economic gain, including, but not limited to, the following:

(1) the maintenance of an office or other place of business in North Carolina;

(2) the maintenance in North Carolina of an inventory of merchandise or material for sale, distribution or manufacture, regardless of whether kept on the premises of the taxpayer or in a public or rented warehouse;

(3) the selling or distributing of merchandise to customers in North Carolina directly from a company-owned or

operated vehicle when title to the merchandise is transferred from the seller or distributor to the customer at the time of the sale or distribution;

(4) the rendering of a service to clients or customers in North Carolina by agents or employees of a foreign corporation;

(5) the owning, renting, or operating of business or income-producing property in North Carolina including, but not limited to, the following:

(A) Realty;

(B) Tangible personal property;

(C) Trademarks, tradenames, franchise rights, computer programs, copyrights, patented processes, licenses.

(b) Corporations who are partners in a partnership or joint venture operating in North Carolina are considered to be "doing business".

(c) "Doing business" by an interstate motor carrier is defined as the performance of any of the following business activities in North Carolina:

(1) The maintenance of an office in the State;

(2) The operation of a terminal or other place of business in the State;

(3) Having an employee working out of the office or terminal of another company.

(4) Dropping off or gathering up shipments in the State.

APPENDIX H

[1] EXPERT OPINION OF PROFESSOR RICHARD D. POMP[1]

North Carolina Department of Revenue v. A&F Trademark, Inc.; Caciqueco, Inc.; Expressco, Inc.; Lanco, Inc.; Lernco, Inc.; Limco Investments, Inc.; Limtoo, Inc.; Structureco, Inc.; V Secret Stores, Inc.

Introduction

You have contacted me as the former Director of the New York Tax Study Commission and as someone who for nearly 25 years has studied, lectured, taught, published, and consulted with, and testified on behalf of state governments, regarding issues of state taxation.

You have asked my opinion about the policies that distinguish due process nexus from commerce clause nexus. In addition, you have asked whether physical presence or metaphysical presence is more compatible with the values underlying the commerce clause. Specifically, you have asked my opinion on whether physical presence or metaphysical presence is more consistent with sound tax policy.

Your inquiry grows out of an attempt by the North Carolina Department of Revenue ("Department") to tax royalties received by out-of-state corporations. These corporations own certain trademarks and service marks, which are licensed for use by taxpayers doing business in North Carolina. I understand that these out-of-state corporations have no physical presence in North Carolina. That is, they neither

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[1] Alva P. Loiselle Professor of Law, University of Connecticut Law School; Adjunct Professor of Law, NYU Law School (LL.M Program in Taxation); Adjunct Professor of Law, Columbia Law School.

own nor lease any tangible or real property in North Carolina. Further, they have no employees, representatives, or jobbers in North Carolina. Their only relationship with North Carolina is that they receive royalties from taxpayers doing business in North Carolina. Apparently, the position of the Department is that the out-of-state licensors have intangible property present in the State and that this intangible property provides sufficient nexus for North Carolina to tax the royalties the licensors receive.

Due Process Nexus and Commerce Clause Nexus: An Overview

As background for understanding the policy considerations that are relevant in analyzing the position of the Department, you have asked me the difference between due process nexus and commerce clause nexus. Due process nexus is concerned with the fundamental fairness of governmental activity. It requires a state to ask whether a person's connections with it are substantial enough to legitimate the state's exercise of power over that person. "Notice" or "fair warning" are the analytic touchstones of due process nexus.

In contrast, commerce clause nexus is informed by structural concerns about the effects of state taxation on the national economy. A state must ask whether its actions hinder, suppress, or unduly [2] burden interstate commerce. Commerce clause nexus is a means for limiting state burdens on interstate commerce.

As this brief description suggests, due process nexus is a very different concept from commerce clause nexus and a person that has due process nexus with a state does not necessarily have commerce clause nexus. The Department's

position regarding the taxation of the royalties raises questions concerning both types of nexus, but my opinion is limited to only the policy considerations surrounding commerce clause nexus.

There is no doubt that commerce clause nexus can be satisfied by a person's physical presence. This physical presence standard has the blessing of the U.S. Supreme Court and that of all state courts. As the name implies, physical presence or physical nexus refers to the presence in a state of tangible property or of personnel of the taxpayer. Physical nexus has a long history and tradition and provides a standard that in nearly all cases is unambiguous and easily applied. Moreover, physical presence provides a determinate solution to the issue of nexus because property or persons cannot simultaneously exist in more than one state.

The out-of-state corporations that the Department seeks to tax do not have any physical presence in North Carolina, and I do not believe the Department is challenging that proposition. Instead, the Department seems to be applying a new standard of commerce clause nexus: metaphysical nexus. Metaphysical nexus is an incorporeal standard, which does not require that a taxpayer have any physical presence in a state. Rather, a taxpayer is present because of various legal relationships that exist between itself and nonphysical, intangible property. In the present case, the Department's position seems to be that the out-of-state corporations are present in the State because of their license agreement with taxpayers doing business in North Carolina.

A Policy Evaluation of Physical and Metaphysical Presence

You have asked me to evaluate from a policy perspective the merits of physical presence nexus versus metaphysical presence nexus. Various criteria exist for evaluating the relative merits of these competing nexus standards in the context of the values and goals that underlie the commerce clause. The criteria that are evaluated below ask which nexus standard is: (1) more consistent with a bright line test; (2) more consistent with settled expectations; (3) more likely to reduce litigation and foster interstate investment; (4) less likely to discriminate against the service sector; (5) less likely to lead to multiple taxation; and (6) more likely to be fairly or easily administered.

For the reasons explained below, I conclude that physical presence is clearly superior to metaphysical presence as a nexus standard when measured against any of these relevant, principled criteria. Further, I conclude that the nexus standard for income taxes should be the same as the nexus standard for sales and use taxes. Finally, I conclude that a metaphysical presence nexus standard may actually reduce North Carolina income tax revenue.

[3] 1. Physical presence is more consistent with a bright line test

The U.S. Supreme Court has emphasized the need for a bright line rule for commerce clause nexus. The reason for a bright line rule is that a nexus standard operates in a stark, all or nothing fashion: a company will either be subject to an income tax or it will not. The need for a bright line test is especially acute where millions of dollars of income taxes can turn on whether nexus exists.

From this policy perspective, an overwhelming virtue of the physical presence standard is that it provides a bright line test. People or tangible property are visible and can be identified through physical observation. Their existence and presence is unambiguous; people or property are either in a state or they or [sic] not.

In sharp contrast, metaphysical presence is an amorphous concept, having no crisp edges. As the dictionary recognizes, intangible property "cannot be easily defined, formulated, or grasped."[2]

Unlike persons or tangible property that can be identified geographically, intangible property cannot be located in any particular state except through legal fictions or doctrines. Various legal fictions include the doctrine of mobilia sequuntur personam, which treats intangibles as being attached to the person that owns them. Another legal fiction locates an intangible at the payor's residence. Yet another approach creates the fiction that an intangible has a business situs.

The problem that arises with these legal fictions is that they do not produce a unique solution to where an intangible is located. For example, the doctrine of mobilia sequuntur personam, when applied to a corporation, can assign intangibles to either the legal domicile of a corporation or its commercial domicile. Further, even the common rule that provides that certain types of intangibles, such as copyrights and patents, are located in the place in which the property is used, does not necessarily locate the intangible unambiguously in only one state. Consider, for

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[2] Webster's New Universal Unabridged Dictionary (Deluxe 2nd ed.).

example, a manufacturer that enters into a license agreement allowing it to use a secret process to produce and sell widgets. One state might locate the license agreement in the state of manufacturing whereas another might locate it in the state of sale.

Intangible property is not capable of being observed and physically located in one unique state. By contrast, no one can dispute the location of a person or of tangible property. Compared with a physical presence standard, metaphysical presence not only provides no bright line rule, but also provides no determinate or unique answer to the nexus question. A rule that can locate an intangible simultaneously in more than one state is not a principle of nexus but rather an invitation to chaos.

[4] **2. Physical presence is more consistent with settled expectations**

There is no U.S. Supreme Court case holding that metaphysical presence satisfies commerce clause nexus. All of the U.S. Supreme Court cases dealing with commerce clause nexus for corporate income tax purposes involved corporations that had a physical presence. Indeed, taxpayers have been very careful in structuring their activities to avoid having a physical presence in those states in which they did not wish to have nexus. In my opinion, the expectation of corporate taxpayers is that no nexus exists under the commerce clause without physical presence.

The metaphysical presence rule is obviously inconsistent with this expectation. If this expectation is to be frustrated by the imposition of a new, metaphysical presence rule, Congress is the appropriate body to do so. Corporations relying on the physical presence standard have not filed

income tax returns on the justifiable assumption that nexus did not exist. Without the filing of a return, the statute of limitations does not run in most states and localities. Consequently, enormous retroactive exposure exists if a new nexus standard is adopted by a jurisdiction. Congress is the ideal body to balance the interests of the various parties should it decide that the commerce clause nexus standard should be changed.

3. Physical presence will reduce litigation and foster interstate investment

The physical presence nexus standard has the weight of history and tradition behind it. It has been litigated over the years and its boundaries are well known and accepted. It provides a knowable and determinable standard. Long-standing precedent supports the standard, which furthers the stability and orderly development of the law. A long-standing doctrine like that of physical presence offers the kind of stability and predictability that fosters interstate investment.

Metaphysical nexus, by the very nature of intangible property, invites years of litigation. The very fact that intangible property does not physically exist in the way that tangible property or persons exist is an invitation to endless litigation and chaos. Metaphysical presence cannot be expected to have the same crisp, sharp edges as a concept as does physical presence, even after years of litigation. The uncertainty and cloud over the concept of metaphysical nexus can only discourage certain types of interstate investment and thereby thwart the goals of the commerce clause.

4. Metaphysical presence discriminates against the service sector

The physical presence nexus standard has helped maintain tax parity between the service sector and the manufacturing and mercantile sectors of the economy. The manufacturing and mercantile sectors have been the beneficiaries of a special federal nexus statute, Public Law 86-272. The physical presence nexus standard complements Public Law 86-272 in a very significant way that helps maintain a level playing field between the manufacturing and mercantile sectors and the service sector.

Specifically, Public Law 86-272 provides a federal nexus standard by preventing a state from taxing the income of a corporation whose only business activities within the state consist of the solicitation [5] of orders for *tangible personal property*. Public Law 86-272 is limited to tangible personal property and does not extend to services. This limitation is presumably explained by two factors. First, the law was enacted in order to overrule Northwestern Portland Cement, which upheld the imposition of a tax on the income of a purely interstate taxpayer selling tangible property – not services.

Second, the law was adopted in 1959, at a time when the service sector was greatly overshadowed by the manufacturing and mercantile sectors. Further, the service sector tended to be intrastate in nature and not interstate. Accordingly, when Public Law 86-272 was adopted, Congress was focussing on the sale of tangible personal property and not on the relatively insignificant interstate service sector.

As interstate services grew in importance and significance, the physical presence rule allowed the service sector to

achieve similar protection to that extended to the manufacturing and mercantile sectors under Public Law 86-272. Physical presence nexus is to the service sector what Public Law 86-272 is to the manufacturing and mercantile sectors.

The understanding and expectation of interstate service providers is that as long as they solicit in a state without having people or property in that state, no commerce clause nexus exists and no income tax can be imposed. The requirement of physical presence thus allows the service sector to achieve nearly the same treatment as those persons that are protected by Public Law 86-272. Accordingly, the physical presence standard helps maintain competitive equity between persons that provide services and those competitors that provide tangible personal property.

A metaphysical presence rule would upset this balance and accommodation. Metaphysical nexus would exaggerate, rather than reduce, the competitive inequities of Public Law 86-272. The result would be to move away from a level playing field and discriminate against service providers, thus interfering unfairly and inequitably with the most rapidly growing sector in the U.S. economy.

5. Metaphysical presence will lead to multiple taxation

As discussed above, intangible property has no corporeal form and does not physically exist. Intangible property can be located in a state only through arbitrary rules that can vary from state to state. Under the existing doctrines, intangible property can be simultaneously present in more than one state, which can easily lead to multiple taxation.

Consider, for example, a corporation that licenses the use of a trademark from L, the licensor. L is incorporated in State I and has its commercial domicile in State C. The corporation agrees to pay a royalty for every good it manufactures and sells bearing L's trademark. Assume the taxpayer manufactures the goods in State M, and sells the goods in State S.

Suppose that State M considers the license to be located in the state of manufacture, that State S considers the license to be located in the state in which the goods are sold, that State C considers the license to be located at the licensor's commercial domicile, and that State I considers the license to be located at the licensor's state of incorporation. Under a metaphysical presence standard, L – [6] the licensor – would have nexus with States M, S, I, and C. The same royalty payment would be taxed by each of these states, resulting in multiple taxation.

As another example, suppose an out-of-state vendor incorporated in State I, having its commercial domicile in State C, sells machinery to a corporation on an installment obligation. The sale is made in State S but later the customer removes the good to State R. Assume the vendor maintains a security interest in the good, which is filed in State R. The customer is incorporated in State D.

State S considers the installment obligation to be located in the state of sale, State R considers the obligation to be located where the security interest is filed, State D considers the obligation to be located at the payor's state of incorporation, State C considers the obligation to be located in the state of the payee's commercial domicile, and State I considers the obligation to be located in the payee's state of incorporation. Under a metaphysical

presence standard, the vendor would have nexus with States S, R, I, C, and D. Income attributable to the installment obligation would be taxed by each of these states, resulting again in multiple taxation.

Perhaps the most graphic way of illustrating the impact that metaphysical nexus would have on commerce clause values would be to imagine that each of the above states attempted to collect the tax due through a withholding mechanism. In other words, the payor would be required to withhold the taxes imposed by States S, R, I, C, and D. States watching their corporations being subjected to withholding taxes all around the country would be invited to retaliate by adopting their own withholding taxes. The widespread adoption of withholding taxes would be inconsistent with the philosophy of the free trade zone that characterizes the United States today. To the contrary, instead of serving as a model for the European Union, which is attempting to eliminate tax barriers to trade, we would be moving in the direction of becoming the United States of Europe.

6. Metaphysical presence cannot be easily or fairly administered as a nexus standard

Metaphysical nexus presents formidable administrative problems. An author receiving royalties from the sale of a book could be taxable in every state in which the book was sold. A television producer receiving royalties by a network for the use of a program could be taxable in every state in which the program was televised. An electronic data bank receiving payments for the use of its services could be taxable in every state in which its logo appeared on a computer screen. A start up company in Silicon Valley

could be subject to tax in every state in which its software licensees operate. A bank purchasing mortgages could be subject to tax in every state in which the underlying mortgagors reside or in which the collateral were located. An athlete receiving royalties from the endorsement of a product could be taxable in every state in which the product was sold.

As these examples suggest, the compliance burdens for taxpayers and administrators would be immense under a metaphysical presence rule. Small and medium sized businesses would be saddled with the obligation to comply with the tax laws of states with which they would have no familiarity. Administrative considerations alone suggest that metaphysical presence is incompatible with the values and goals of the commerce clause.

[7] The Commerce Clause Nexus Standard Should be the Same for Both Sales and Income Taxes

The U.S. Supreme Court has explicitly held that physical presence is the commerce clause nexus standard for sales and use taxes. Three policy considerations dictate that the same standard should apply for income taxes.

First, the commerce clause is concerned with the problem of multiple taxation. Yet the risk of multiple taxation is greater for income taxes than for sales and use taxes. In the case of the sales and use tax, typically there are only two states that can assert jurisdiction over the transaction: the state of origin and the state of destination. In the case of an income tax, however, a transaction may have contacts with numerous states, as the examples above illustrate. No reason exists to think that the Supreme Court is less concerned about multiple taxation when it

occurs in an income tax than when it occurs in a sales tax. The same reasons that led the Court to endorse a physical presence standard for sales and use taxes apply even more strongly in the case of an income tax.

Second, treating income taxes the same as sales and use taxes is not only consistent with the policy values underlying the commerce clause, but also with the language of the clause. Nothing in the language of the commerce clause refers to specific taxes. There is not one commerce clause for sales and use taxes and another for income taxes. No reason exists, therefore, for a state to develop a different (and lower) nexus standard for income taxes than for sales and use taxes.

Third, the orderly development of the law requires that the same nexus standard should apply to both income taxes and sales and use taxes. If metaphysical presence were to apply to income taxes and physical presence to sales and use taxes, confusion would undoubtedly result because two bodies of doctrine would simultaneously develop side-by-side.

Consequently, policy considerations, the language of the Constitution, and the orderly development of the law require that physical presence be the nexus standard for both income taxes and sales and use taxes.

Metaphysical Presence will Result in more Corporations Apportioning their Income Outside of North Carolina with the Likelihood that State Revenue will Decline

Establishing a metaphysical presence test might very well be a Pyrrhic victory for the State. Under North Carolina

law, a corporation can apportion its net income outside of North Carolina only if it is taxable in another state. A corporation is taxable in another state if its activity in that state subjects it to an income tax *regardless whether that state exercises its jurisdiction.* N.C. Gen. Stat. Ann. §105-130.4(b) (emphasis added). In determining whether a corporation is taxable in another state, that state is assumed to have North Carolina law.

Under a metaphysical presence standard, many more intrastate corporations would now be considered as taxable in states other than North Carolina. Accordingly, corporations not previously apportioning their income outside of North Carolina would now be entitled to do so. It would be irrelevant that these corporations would be apportioning income to states that did not actually have a metaphysical presence standard so that no tax would be imposed.

[8] Consequently, any intrastate corporation will be encouraged to interpret aggressively the meaning of metaphysical presence in order to claim the right to apportion income. An aggressive interpretation will be cost-free if the state to which the corporation is seeking to apportion its income is using a physical presence standard; the corporation will not be taxable by that state regardless of whether metaphysical presence would exist or not. Because the majority of states use physical presence, the result will be that intrastate corporations will be unbridled in their attempts to apportion income, with a concomitant loss in North Carolina revenue. While some of this loss may be offset by the increase that will result if the State is successful in asserting metaphysical presence, the limitations inherent in the audit process suggest that

the greater likelihood is that North Carolina will lose revenue.

Conclusion

By any principled measure of comparison, physical presence is to be preferred to metaphysical presence as a nexus standard. Physical presence is more consistent with a bright line test, more consistent with settled expectations, more likely to reduce litigation and foster interstate investment, less likely to discriminate against the service sector, less likely to lead to multiple taxation, and more easily administered.

The Constitution does not distinguish between sales and use taxes and income taxes: there is only one nexus standard and the U.S. Supreme Court has endorsed physical presence.

It is tempting to view a metaphysical presence standard as raising revenue, as it would do in the particular case at issue. The greater likelihood, however, is that metaphysical nexus may actually reduce – rather than increase – North Carolina revenue.

The country has little experience with administering a metaphysical presence standard; the concept is amorphous and easily malleable. Metaphysical presence is less a legal principle and more an invitation to chaos and multiple taxation, thus undercutting the very goals of the commerce clause that the concept of nexus is intended to further.

APPENDIX I

NEXUS AND STATE CORPORATE INCOME TAXATION

by

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David E. Wildasin, Curriculum Vitae .....[Intentionally Omitted]

[1] NEXUS AND STATE CORPORATE INCOME TAXATION

I. Introduction and Summary

The issue of nexus for state corporation income tax purposes has potentially far-reaching implications. The resolution of this issue will affect not only individual states but the functioning of the economic system as a whole. It should be resolved in a way that recognizes both

the legitimate economic interests of state governments and the national interest in sound economic policy. In a federal system like that of the United States, states must be able to utilize fiscal instruments that allow them to perform their essential economic functions; at the same time, they should not implement policies that impede the efficient functioning of the economic system or that impose inappropriate burdens on the rest of the nation. Policies that are in the interest of an individual state acting alone – in the present context, an excessively broad definition of nexus for corporation income taxation – may be harmful to the collectivity of all states. The taxing powers of the states should not be so constrained that they are unable to carry out their critical public functions, but at the same time they should be sufficiently constrained that the exercise of their powers is not harmful to the nation.

As will be shown below, it is inappropriate for states to use the licensing of intangibles as a basis for determining nexus for state corporation income tax purposes.[1] Rather, economic policy considerations support the use of a physical presence test for this purpose. A physical presence test allows states to use the corporation income tax, if they wish, to recover the costs of public service provision that corporations may impose upon them. This promotes economic efficiency by insuring that those whose presence requires the expenditure of state government resources

[1] The discussion below considers whether the licensing of an intangible constitutes an appropriate basis for establishing nexus. The principles underlying this discussion, however, are equally applicable to other types of transactions involving intangibles; from the perspective of fiscal policy, there is no important distinction between the licensing of intangibles, their outright sale, or other contractual forms through which property rights in intangibles may be exchanged.

share the burden of those expenditures. Corporations that are linked to a state through the licensing of intangible assets, however, do not impose public service provision costs on a state and, accordingly, should not have to share in those costs. Indeed, requiring them to do so creates adverse economic incentives for state policymakers to shift the burden of financing state activities away from households [2] and businesses who impose real costs to those who do not. Moreover, such policies distort the organizational form of business activity and the structure of commercial transactions. While it may be in the interest of individual states to pursue such policies, they are harmful to national economic performance.

As detailed in this report, these conclusions are based on fundamental economic principles of fiscal policy. Section II outlines these principles, emphasizing the importance of economic efficiency considerations in the formulation of the policies of subnational (state and local) governments. The implications of these basic principles for the taxation of business activity are described in Section III. This section describes how subnational governments must take the geographic mobility of business activity into account in the formulation of fiscal and other policies, and how competition among these governments in such an environment tends to promote efficient economic policy choices. As discussed in detail in Section IV, these considerations show that a physical presence test is a sound basis on which to establish nexus for corporation income tax purposes. Finally, Section V reviews some of the adverse economic consequences that can be expected if a corporation with no physical presence in a state is exposed to income taxation because it sells or licenses intangible assets there.

II. General Normative Principles of Fiscal Policy in a Federal System

A substantial body of economic research has been devoted to the normative analysis of fiscal policy in federal systems, and the basic principles of fiscal federalism that have emerged from the writings of numerous scholars can be used to guide the analysis of the nexus issue. From a broad normative economic perspective, the public sector as a whole should pursue fiscal and regulatory policies that promote economic efficiency, equity and fairness, and macroeconomic stability. No one level of government is uniquely best-suited to manage all aspects of policy, however. State and local governments, for example, are not able to influence macroeconomic conditions effectively and it is appropriate, therefore, for Federal fiscal authorities and the central bank to take responsibility for macroeconomic policy.

From the viewpoint of economic efficiency, governments can play an important role in providing goods and services that yield real economic benefits but that are not provided at all, or that are provided inadequately, by the private sector.[2] Efficiency in public-[3]sector provision of goods and services, as also in the private sector, requires a balancing of benefits (or demand) and costs (or supply). Lower-level governments are generally in a better position to assess and respond to demands for public services whose benefits are enjoyed primarily by households and

[2] For example, it can be excessively costly or even impossible to charge prices for access to thoroughfares or for public health and sanitation measures, which implies that private provision of these important goods and services may not occur at all or may be inadequate.

firms located within their boundaries; they often have better information about the impact of the goods and services that they provide and they also have incentives to use this information effectively. By contrast, states and localities are not the appropriate levels of government to provide goods and services whose benefits are widely distributed throughout society, since it is difficult for them to ascertain what those benefits are and since it is the responsibility of state and local policymakers to pursue policies that promote the interests of their residents, not those of the nation as a whole. Rather, the Federal government should take primary responsibility for policies and functions whose benefits accrue widely throughout society.[3]

In addition to promoting macroeconomic stability and efficient provision of public goods and services, the public sector pursues policies that affect the distribution of income in society. For instance, at the Federal level, the personal income tax plays a major role in distributing the cost of financing the Federal government within the taxpaying population. Alternative specifications of Federal income tax policy – notably, the structure of tax rates and the definition of income for tax purposes – would distribute this cost differently. A more progressive rate structure, for example, would effectively redistribute income away from higher-income taxpayers toward those with lower incomes. The expenditure side of the Federal budget is also heavily engaged in the redistribution of income, for

[3] These economic principles are of course generally reflected in the assignment of powers under the Constitution, and indeed could be viewed simply as a restatement and elaboration, in economic language, of constitutional principles.

instance through programs of cash and in-kind transfers such as social security and health care finance for the elderly.

Government-directed redistribution of income almost invariably affects economic incentives. Very high personal income tax rates, for example, can discourage work effort and saving. These incentive effects disturb the efficient functioning of the economic system and limit the effective redistributive impact of fiscal policy. Redistribution by state and local governments can create even more severe harm to economic incentives than Federal government policies because households and firms are relatively mobile among subnational governments. A state or locality that imposes high tax burdens on some class of house-[4]holds or businesses will create incentives for existing taxpayers in that class to leave the jurisdiction and will discourage entry by new taxpayers; conversely, benefits derived from state or local government expenditures that are directed toward a particular class of households or businesses create fiscal incentives for existing resident-beneficiaries to remain in the jurisdiction and for new potential beneficiaries to enter. Thus, for example, a state that taxes its rich residents heavily in order to provide services or cash transfers for its poor creates fiscal incentives for rich households not to reside in the state and for poor households to gather there. These responses simultaneously (a) interfere with the efficient allocation of resources and (b) limit or negate the distributional impact of redistributive policies. They cause inefficiency because the allocation of resources among jurisdictions – especially the allocation of labor and capital – is determined not only by underlying economic benefits and costs, but in response to artificial fiscal incentives. They negate the distributional

impact of redistributive policies because they drive away those households and businesses who are net fiscal contributors and attract those who are net fiscal beneficiaries, thus limiting the contributions by the former and dissipating the benefits among the latter. Normative economic analysis of multi-level government finance thus leads to the conclusion that subnational governments should not take significant independent responsibility for income redistribution; the redistributive role of the public sector is better assigned to the Federal government. Whereas it is relatively easy for households and firms to change their locations in response to state or local fiscal policies, doing so in response to Federal government fiscal policies entails much more costly and difficult relocation on an international scale. The efficiency cost of Federal redistributive policies is thus lower, and their effectiveness in altering the distribution of income is greater, than for lower-level governments.

In summary, economic analysis indicates that the policies of state and local governments should focus primarily on promoting efficient provision and financing of public goods in accordance with the demands for and costs of these goods and services within their jurisdictions. Attempts to redistribute income (*i.e.*, to impose costs on some households and firms in order to provide benefits for others) interfere with economic efficiency and do not achieve the desired redistributive impact. The mobility of households and firms among subnational governments implies that these governments must "compete" for resources with other governments. State or local policies that create a mismatch between the provision of public services and the burden of financing those services imply that some households or firms are net beneficiaries of

fiscal policy while others bear net fiscal burdens, and households and firms respond to these fiscal benefits and burdens through their lo[5]cational choices. Competition among subnational governments for mobile resources tends to bring fiscal burdens and benefits more closely into alignment, which is the hallmark of efficient fiscal policy. Fiscal competition resulting from the mobility of resources, in other words, works to limit the extent of redistribution undertaken by subnational governments and, at the same time, to improve the efficiency of their fiscal policies. In a system like that of the United States with multiple levels of government, the major economic role of subnational governments is to improve the efficiency of resource allocation by providing valuable public goods and services to their residents and by using taxes, licenses, fees, and charges to apportion the costs of those goods and services among those whose presence is responsible for the public expenditures that must be financed.

III. State Business Taxation and Fiscal Competition

How do the foregoing principles apply to the taxation of business activities by state governments? First, it should be noted that states collect revenues from businesses in many ways. States (and localities, as well) rely heavily on prices or price-like charges and fees to finance many services provided to businesses and, in so doing, they generally enhance efficient resource allocation.[4]

[4] Appendix I provides a brief summary of the structure of government finance at the Federal, state, and local level in the United States, illustrating the relative importance of different types of revenue instruments for different levels of government.

State-owned corporations or agencies may provide electrical power or water for business users and invariably charge for the use of these services. It is commonplace for state and local governments to charge for the use of highways through vehicle licensing, taxation of vehicles, or taxation of fuels. State and local agencies that manage harbors and airports charge users of these facilities, directly and indirectly, for the services that they provide. Underpricing or undercharging for the provision of these facilities and resources leads to their excessive (i.e., economically-inefficient) utilization. The general principle of efficient public pricing is that prices, charges, fees, etc. should reflect the cost that a firm (or household) imposes on the public sector by virtue of its utilization of publicly-provided goods and services. Business activities that do not impose a service-provision burden on a state or locality should not be priced or taxed.

The process of fiscal competition among subnational governments generally promotes more efficient taxation and pricing. Some business activities impose far fewer costs on a jurisdiction than others, for instance because they do not congest public facilities or do little environmental damage. Some business activities may produce spillover benefits to [6] a jurisdiction by providing attractive employment opportunities or by promoting desired patterns of economic development in other ways. States and localities face strong incentives to attract such activities because they do not impose high fiscal or other burdens on the jurisdictions where they reside. Subnational governments can compete for such activities in a variety of ways, for instance by instituting favorable tax policies or regulatory environments or by undertaking public expenditures that attract desired forms of business. By contrast,

business activities that impose substantial costs on the jurisdiction where they locate – for instance in the form of heavy burdens on public infrastructure, public safety, or the local environment – are less attractive to states and localities. The process of competition among governments can be expected to result in heavier tax burdens, higher prices for licenses, and heavier regulatory burdens for such businesses. In either case, fiscal competition works to insure that businesses are made to pay for the costs that they impose on the jurisdictions where they locate, and this in turns promotes economically-rational resource allocation. Activities that are particularly burdensome to particular jurisdictions are likely to face fiscal incentives that make it unattractive for them to locate there, while more benign activities will face more favorable fiscal and regulatory incentives. Uniformity of policies among states and localities is not to be expected, as the benefits and costs of different types of business activity differ among jurisdictions and over time. The process of fiscal competition leads jurisdictions to structure their fiscal and other policies in ways that appropriately reflect local conditions and, in this way, it contributes to efficient patterns of business and other economic activity.

State corporation income taxes can certainly play some role in an efficient structure of business taxation. However, they are assessed on the basis of corporate profits rather than in relation to the demands that a corporation places on a state's public goods and services.[5]

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[5] For example, a corporation that is unusually innovative in the development or marketing of new products or in finding less costly means of production may have substantially higher profits than one that is poorly managed; under a state corporate income tax, the former would have to make a larger fiscal contribution than the latter for

(Continued on following page)

Furthermore, the corporate form of organization in itself does not generally imply that a business imposes higher costs on state and local governments than similarly-situated unincorporated enterprises. Of course, these normative considerations need not in themselves be taken into account by state policymakers in their determination of the fiscal treatment of business. However, the location of corporate business activity may be quite sensitive to state corporate income tax burdens, and state policymakers certainly do have [7] reason to be closely concerned with this potential consequence of their tax policy choices. States can and should (and, under the Constitution, do) have the flexibility to adapt their tax and other fiscal policies in accordance with the interests of their residents, but they must also bear the consequences of their policy choices.

In summary, the tax policies of state and local governments should promote efficient resource allocation in the United States economy. The location of business activity, including production and employment, should be determined in accordance with underlying economic conditions of cost and demand and should not be distorted by artificial fiscal incentives. Efficiency dictates that businesses should bear the costs that they impose on the state or local public sector, and the process of fiscal competition among subnational governments, each acting in accordance with the interests of their own residents, has led them to develop revenue structures that generally reflect these efficiency considerations.

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reasons that have nothing to do with the costs that the business may impose on the state.

IV. Nexus and the Physical Presence Test

As described above, efficient state and local taxation of businesses and households requires that they bear the costs that they impose on states and localities for the provision of public services. What does this imply about the issue of nexus for state corporation income taxation? In particular, should a corporation that licenses or sells intangible assets or products in a state be subject to that state's corporation income tax?

In practice, it is the physical presence of firms (and households) that imposes service-provision burdens on subnational governments.[6] The use of public facilities and services by businesses physically present within a state may necessitate the expenditure of additional state resources. Businesses that are physically present may cause harm to other residents in the form of congestion, noise, or other environmental disamenities. States and localities can and do utilize a wide variety of revenue (and regulatory) instruments to make businesses bear the costs that they impose on the public sector or on other residents. The mere transfer of intangible property rights to individuals or businesses within a state by an out-of-state enterprise, however, imposes costs upon the state that are zero or negligible. Such transactions do not, in themselves, crowd the highways, require fire and police protection, [8] demand

[6] See Appendix II for an enumeration of expenditure categories for state and local governments in the US. A review of these categories makes clear that the public services provided and public expenditures undertaken by states and localities – whether in North Carolina, or, more generally, in any of the states – are not attributable to businesses not physically present within their jurisdictions.

additional expenditures for universities or local schools, or in other ways impose burdens on state or local governments or residents within their jurisdiction. For this reason, there is no economic efficiency rationale for imposing corporation income taxes on corporations not physically present in a state.[7]

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[7] It could be argued that out-of-state corporations benefit from the protection of a state's laws and courts; even if the conduct of their business does not entail their physical presence in a state, circumstances might arise in which a corporation's employees are required to appear physically before a state's courts, and thus the corporation could be said to have a "contingent" form of physical presence. These exceptional cases do not form a valid basis for arguing that a corporation should be subject to state income taxation, however. First, states can impose charges for access to their courts, and such charges provide an economically-appropriate revenue instrument by which states can recover the costs imposed on them by litigants. Second, the taxation of a corporation's income merely because it might occasionally appear in a state's courts (indeed, might be *compelled*, even by the state itself, to appear in a state's courts), would be a grossly disproportionate fiscal burden; the occasional and contingent use of a state's courts fails to pass a reasonable *de minimis* test. Third, almost every corporation in the entire country (and individual, for that matter) could be deemed to have nexus for tax purposes under this test, which is therefore quite unreasonable. To illustrate, suppose that a corporation (or individual) located in state A is defamed by a malicious party located in state B, for instance in order to gain commercial advantage in some fashion. Suppose that the corporation in state A is engaged in no interstate commerce whatsoever. To protect itself, the corporation would have to bring suit in the courts of the state where the defamation occurs. The fact that it does so, or might under some future circumstances do so, cannot reasonably be used to establish nexus for corporation income tax purposes, since this would imply that every corporation (and, for that matter, every individual) would be liable for the payment of state income taxes in every state. The "protection of the courts" argument for establishing nexus might be justifiable if applied to firms that are physically present in a state but is certainly inappropriate when applied to corporations not physically present.

Of course, out-of-state firms may benefit indirectly, in numerous ways, from the services that a state provides to the households and firms located within its boundaries. Moreover, trade with out-of-state corporations may well promote economic development, population growth, and other economic, demographic, and social consequences that result in greater public service demands and expenditures at the state and local level. It might conceivably be argued that these consequences justify the imposition of corporate income taxes on businesses with no physical presence in a state. This argument, however, would be a misapplication of the principles of efficient taxation described above.

To see this, it may be useful to consider a simple example. It is obvious that local fire and police protection and state and local provision of roads may well protect and enhance the business activities of retail booksellers located within a particular state. Expansion and development of local retail enterprise in turn raise the demand for the goods and [9] services that retailers handle, such as books provided by out-of-state publishers, and thus increase the revenues that these out-of-state firms derive from sales within the state. But local retailers and out-of-state publishers are really just intermediaries between authors and their readers. Authors, through their creative efforts, produce the fundamental intangible assets on which the businesses of retailers and publishers are based. Both authors and readers, of course, benefit from the efforts of publishers, local retailers, and other intermediaries because they facilitate access to the underlying intangible assets that authors create. State and local governments who provide services to local booksellers likewise indirectly provide important benefits to authors and to

readers. In particular, the incomes of authors are certainly enhanced by state and local government policies that facilitate the effective distribution and marketing of the intangible assets that they create.

The fact that the creators, owners, and developers of intangible assets derive some indirect economic benefit from state and local government policies, however, does not imply that state taxation of their incomes is warranted. Rather, to the extent that firms like booksellers impose public-service provision costs on state and local governments, they should pay fees, charges, or taxes that reflect those costs. Such taxes and charges may indeed reduce the incomes accruing to the owners of intangible assets even though they are not physically present and are not subject to a state's corporation income tax. For example, corporation income taxes levied on booksellers physically present in a state may ultimately reduce the incomes of authors or raise the price of books to readers.[8] To the extent that this occurs, local booksellers function as tax collectors through which state and local governments recover costs that they incur for services that indirectly benefit authors and readers. And, from the viewpoint of economic efficiency, this is as it should be. All of the real

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[8] If retail booksellers were exempted from all state and local taxes, or, to make the point even more strongly, if they were directly subsidized by state and local governments, the prices paid by consumers for books would fall and the incomes that authors could obtain for their manuscripts would rise, reflecting a reduction in the effective cost of bringing authors' ideas to the marketplace. In this sense, it is the authors and readers of books who bear the burden of state and local taxes on retail booksellers. It is noteworthy that the distribution of the burden of these taxes does not depend on whether the authors (or readers, for that matter) are physically present in the taxing jurisdiction.

economic costs involved in economic activities, including the costs of public services, should be reflected in the prices facing producers and consumers. Efficient state and local taxation of establishments physically present within their jurisdiction will insure that this is the case.

Note that the basic principles identified above – that corporation income or other [10] business taxes should reflect the costs of public service provision, and that these costs are related to physical presence – are conducive to a structure of taxation that reflects underlying economic realities rather than technical (and sometimes almost metaphysical) distinctions that may otherwise arise in determining nexus for state corporation income tax purposes. In the preceding example, it is irrelevant whether an author prepares a manuscript on paper or, instead, uses a network to send the manuscript to the publisher as an electronic file, a minor distinction which should hardly be the basis of significant differences in tax treatment. It is irrelevant whether a large fraction of the price paid by a local bookseller to an out-of-state publisher reflects the physical cost of producing the book or whether it also reflects the value of other, possibly intangible goods or services that may be bundled, explicitly or implicitly, with the book. For instance, the purchase of a computer manual in a bookstore may authorize a consumer to access certain software or technical support services provided over a network by an out-of-state firm, which itself may or may not be a corporation and which may or may not have any linkage of ownership or control with the publisher that sells the book to the bookseller. None of these factors affect the costs that the local retail establishment imposes on the state or locality for the provision of public safety or transportation. The amount of income accruing to out-of-state

enterprises, the extent to which this income reflects a mixture of returns to tangible and intangible goods and services, or the number of intermediate transactions and organizations that lie between the ultimate producer of a good or service and the ultimate consumer of it do not affect the cost of providing public goods and services to the enterprise that is physically present in the state and, on efficiency grounds, should not affect the taxes or charges assessed for the provision of those public services.

V. Basing Nexus on Intangibles: Adverse Economic Effects

As discussed in preceding sections, taxing the income of corporations not physically present in a state is not necessary for the states to recover from corporations the burden of providing public services to them. In fact, basing nexus for corporation income tax purposes on the licensing of intangibles in a state has several adverse economic consequences. First, allowing states to use the corporation income tax to capture a share of the income accruing to out-of-state corporations with no physical presence creates adverse incentives for states to shift fiscal burdens to non-residents. Second, exposing corporation income to state taxation solely because of the licensing of intangibles leads to intersectoral fiscal distortions and to distortions of the organizational structure of business. Third, taxing a corporation's income merely because it derives revenue from the sale or licensing of goods [11] and services to purchasers who reside in another state erects a barrier to the freedom of commerce across state boundaries, inhibiting free trade within the internal market of the United States. Fourth, basing nexus on the fact that a corporation derives revenue from transactions involving intangibles

would be inconsistent with the tax treatment of corporations that derive revenue from the sales of tangible goods. These adverse consequences are discussed in more detail in the present section.

A. Nexus and the Potential for Tax Exporting

A basic premise of the economic analysis of fiscal federalism is that subnational governments have incentives to advance the interests of their residents. This promotes economic efficiency when these governments provide public services demanded by their residents and when they are motivated to do so in a cost-effective fashion. However, subnational governments are equally motivated to promote local interests at the expense of broader, national interests. In particular, they have incentives to shift fiscal burdens to non-residents if they can. The use of state or local tax policy to shift the burden of public finance to non-residents is known as "tax exporting", and it can take a variety of forms. By shifting tax burdens to unrepresented non-residents, tax exporting can distort the economic incentives facing subnational governments, inducing them to undertake expenditures and programs whose local benefits are not sufficient to outweigh their true economic costs.

In the present instance, it is clear that intangibles-based nexus for corporation income tax purposes would allow states to collect revenue from out-of-state corporations that do not impose public service provision burdens on them. From the viewpoint of the residents of a state and of the elected officials who represent their interests, this form of taxation offers the prospect of a true fiscal windfall. As such, the states have powerful incentives to

attempt to exploit it. Normally, states are limited in their capacity to impose tax burdens on potentially mobile households and firms. As discussed previously, it is the ability of mobile households and firms to escape taxes in any one jurisdiction that gives rise to fiscal competition among subnational governments, inducing these governments to establish structures of taxation, public pricing, regulation, and expenditure that promote economic efficiency. However, to the extent that states have the power to tax income accruing to non-residents (whether households or firms) in ways that are unrelated to the cost of providing public services to them, they are able to create and maintain a mismatch between the costs of public service provision and the distribution of those costs. Allowing nexus to be based on the licensing of intangibles means that states can shift the burden of [12] public service provision from those households and firms on whose behalf these costs are incurred to non-residents – specifically, the owners, employees, and customers of out-of-state corporate enterprises – who do not impose costs on the state.

As understandably attractive as such an arrangement may be from the perspective of an individual state, it is harmful to the national interest. Insofar as states acting individually can shift the costs of their public services to outsiders, they lack the incentive to provide public services at least cost and to provide only those services whose benefits are sufficiently great to warrant the diversion of scarce economic resources from the private to the public sector. Furthermore, when households and firms do not bear the costs of service provision that they impose on subnational governments, their locational decisions are likely to be economically inefficient. When states tax the

income of corporations not physically present, they pursue policies that distort locational incentives and produce an inefficient spatial distribution of households and business activity.

In summary, a physical presence test for state corporation income taxation appropriately constrains the taxing powers of states so that, in pursuing their individual interests, they enhance rather than harm the efficiency of resource allocation and thus improve rather than harm the functioning of the economic system as a whole.

B. Nexus, Organizational Form, and Intersectoral Resource Allocation

Basing nexus for state corporation income taxes on the licensing of intangibles creates incentives that impose economic harm by distorting the organization of business enterprise, the structure of intangibles-related transactions, and the allocation of resources among different sectors of economic activity.

To begin with, one should note that it is increasingly feasible and commonplace for business activities to be integrated over space, for instance by conducting different parts of an enterprise's activities (*e.g.*, production of industrial components, assembly, financial management and control, marketing, or purchasing) in different locations. There are numerous underlying economic reasons that determine the form of such arrangements (and their continuous adjustment and revision), including differences in product and input prices across regions, differences in the quality or availability of different inputs (*e.g.*, access to raw materials, pools of specialized labor, proximity to financial markets, *etc.*). Subject of course to the costs of

coordinating and managing geographically-dispersed activities, there are great potential efficiency gains from such forms of business organization. Continued [13] technological progress, including improvements in electronic communication, has resulted in substantial reductions in the costs of all types of communication and transportation and enhances the scope for new and more productive mechanisms of business coordination, control, production, and product distribution. Many of these potential developments involve intangibles transactions.

Especially in an environment where transactions costs are falling, the precise legal forms of organization through which economic activities are undertaken can be quite fluid. For example, a corporation may contract with other businesses, such as banks or accounting firms, to provide various financial services. Alternatively, it may hire its own financial and accounting staff in order to manage its financial structure. A firm that relies on innovation and invention to develop new products may hire a staff of research scientists to develop new ideas or it may instead (or also) purchase patents from other incorporated or unincorporated firms or individuals. It may hire computer programmers to develop proprietary and firm-specific software or it may purchase software from firms that specialize in software development; if it uses in-house software developers, these individuals will almost certainly utilize operating systems and applications development tools that have been developed by other incorporated or unincorporated businesses or individuals. There is no one best or uniquely standard way of organizing these types of activities.

When taxes fall on specific types of transactional forms, they create burdens on particular ways of organizing economic activity and in doing so create fiscal incentives favorable to some forms of organization and, implicitly or explicitly, adverse to others. When these taxes appropriately reflect underlying economic factors (for example, the costs of public service provision, as described earlier) they encourage efficient resource allocation. If they are not directly or indirectly based on such economic factors, however, they impede the efficient functioning of the economy. In the present case, it is not difficult to see how determining nexus for corporation income tax purposes as a result of intangibles transactions can create perverse economic incentives. Suppose that two companies are deemed to be "sufficiently closely related" that the income that one, located in state A, derives from the licensing of intangibles to the other, located in state B, exposes it to corporation income tax in state B. This creates a fiscal incentive for the two firms to become "insufficiently" closely related. Depending on the activities in question, this could be done with greater or lesser ease.

For example, authors typically do not own their own publishing businesses but rather sell or license the right to publish their works. Publishers often do not operate their own [14] retail establishments, relying instead on other firms to distribute their books. These layers of transactions between authors and readers (the publishing industry and retail booksellers) presumably have important economic advantages. They also create sufficient transactional and organization "distance" between authors and readers that authors do not have nexus, for state corporation or personal income tax purposes, in all of the locations where their works are sold.

In the case of authors and readers, it may appear obvious that the former should not have nexus for tax purposes in the states of residence of the latter and perhaps no state would attempt to exert tax jurisdiction over out-of-state authors. However, this case does not differ, in its economic essentials, from other cases where transactions involving intangibles might be used to justify the exercise of state taxing powers. For example, suppose that an engineering firm based in state A provides various consulting services to businesses throughout the country. The firm may have branch offices, subsidiaries, or other affiliated firms located in several states. In providing its services, it uses various technological concepts and information which it acquires at considerable cost from numerous sources. Some of this information takes the form of databases provided by other "unrelated" firms for which the engineering firm pays subscription fees; these firms may be located in any other state. In the determination of the engineering firm's income for tax purposes, its payments for the acquisition of this information, which it ultimately recovers in the revenue it derives for its consulting services, are treated as a cost. If the firm provides consulting services in state B, and if intangibles provide nexus for business income tax purposes, the income accruing to the firm's operations in state A, as well as the income derived from it various in-state branch or subsidiary operations, might be subject to income tax in state B. The firms that provide the database services to the engineering firm, however, would not be reached by the corporation income tax in state B.

Now suppose as an alternative that the engineering firm in state A acquires the firms from which it previously purchased costly database services. These firms may have

very unique capabilities to gather and process data and may be very profitable; the profits from these operations now accrue to the engineering firm in state A. Assuming that the other facts of the case are unchanged, the engineering firm's acquisition of database services that may be located in other states thus increases the amount of income that is exposed to the corporation income tax in state B. Clearly, this change in organizational structure has no impact on the burden that state B incurs in providing public goods and services to the branch offices or subsidiaries that have physical presence there and it provides no [15] rational basis for a change in the exposure of a firm in state A to income taxes in state B. This example illustrates that basing nexus for state corporation income tax purposes on intangibles transactions brings fiscal incentives to bear on business considerations that have absolutely no connection to the state in which taxes are collected. The integration or disintegration of economic functions within a business enterprise should be driven not by such fiscal considerations but by underlying economic benefits and costs.

Examples of this type could easily be multiplied, but the essential economic principles should now be clear. Organizational and transactional forms can be influenced by tax considerations, and thereby become less effective in performing their fundamental economic functions. In some sectors or spheres of activity, it may be comparatively simple to redesign the structure of firms or transactions so as to limit exposure to state taxes, whereas this may be much more difficult in other industries. If states can use the licensing of intangibles in determining nexus for corporation income tax purposes, some industries or sectors of the economy will be virtually unaffected as a

result of offsetting organizational and legal adaptations, while others will face heavier fiscal burdens that are not so readily escaped. The distribution of fiscal burdens on this basis is arbitrary and, by imposing differential burdens on some sectors, it arbitrarily distorts production and consumption decisions.

In summary, an attempt to base corporation income tax liabilities on nexus as determined by the licensing of intangibles is very likely to lead to economically-inefficient changes in organizational or transactional forms that reduce tax exposure. Even under the most expansive interpretation of state taxing power, states cannot hope to reach large portions of the income that accrues to nonresident creators and developers of intangible assets. Their attempt to do so, however, can cause economic harm. Basing nexus for state corporation income taxes on physical presence allows states to recover the costs that they incur for business activities undertaken within their jurisdiction while inhibiting them from pursuing policies that distort the organizational and transactional form of commerce.

C. Nexus and Internal Free Trade

Preservation of free trade within the United States is of vital economic importance; it is also, of course, a fundamental constitutional principle. States should not be allowed to use fiscal or regulatory instruments that impede the free flow of commerce across state boundaries.

This principle does not mean, of course, that states cannot impose fiscal or regulatory [16] burdens on business activity, even though these policies do affect the structure of interstate commerce. Sections III and IV

above have described how a state may appropriately tax or regulate economic activity so that businesses that operate within its borders have to bear the cost of fiscal, environmental, or other burdens that they create. Obviously, such taxes would tend to reduce the amount of taxed business activity within the state, for instance by discouraging certain businesses from conducting operations within a state whose fiscal climate makes it unattractive for them. Appropriate taxes and regulations, however, improve rather than detract from the efficient functioning of the economic system, and do not erect artificial barriers to free internal trade. From the viewpoint of economic policy (not to mention constitutional principle), however, it is crucial that a state not impose a fiscal burden on individuals or businesses *solely* because they engage in acts of interstate commerce. Furthermore, interstate economic activity should not be subject to discriminatory fiscal or regulatory treatment.

Now consider the issue of nexus for corporation income tax purposes. If a corporation licenses an intangible within a state and has no physical presence there, the *mere act* of engaging in interstate commerce exposes the out-of-state corporation to a fiscal burden. Almost by definition, the licensing of an intangible asset for use in another state is nothing but a pure interstate exchange of property rights that, by virtue of its intangible character, can in itself have no ancillary impact (such as congestion of public facilities or the generation of environmental disamenities) on the states where a license is utilized. To expose a corporation to income taxation in a state because it derives revenue from licensing of intangibles there is thus to create a fiscal barrier to interstate transactions. Indeed, these fiscal barriers are precisely the sorts of

impediments to interstate trade that tend to destroy the free flow of goods and services that exemplify the internal common market of the United States economy. In its technical legal form, of course, taxation of an out-of-state corporation's income is not quite identical to a tax on the importation of goods and services, *i.e.*, a tariff, since it is based on the net income that a corporation derives from its interstate commerce rather than from the number or value of intangibles transactions, *per se*. Allowing states to tax the income of out-of-state corporations solely because they derive revenue from the licensing of trademarks, patents, or other intangible assets to businesses operating within a state, however, has substantially the same economic consequences as the imposition of a tariff. From the viewpoint of the non-resident owner of the intangible asset, it is the mere act of engaging in an interstate transaction that creates a tax liability, exactly as would be the case with a tariff, and economic incentives are distorted for the same reason. The exposure of corporations to state income taxation [17] because of their licensing of intangibles reduces the value of interstate transactions, lowering the return to (and thereby discouraging) interstate commerce. The taxation of a corporation solely by virtue of the fact that it derives revenue (whether net or gross) from sales of intangibles in a state makes the state corporation income tax, in this respect, the functional equivalent of a tariff. This is inimical to free trade within the United States.

D. Consistency in Business Taxation: Tangibles vs. Intangibles

It has been argued above that a corporation should not be subject to corporate income taxation in a state

merely because it derives revenue from the licensing of intangibles to businesses that are located within the state. A principal justification for this position is that corporations with no physical presence do not necessitate the provision of public goods and services and thus do not impose any costs on a state or locality. Clearly, for businesses that do have physical presence in a state, the extent of costs that they impose on the public sector will vary widely depending on the nature of the business activity in question. One can ask, in particular, whether a business that is only connected with a state by virtue of the fact that it sells *tangible* goods there ought thereby to be subject to corporate income taxation. Unlike businesses that have employees or real property in a state, a business that only sells its product in a state has a rather tenuous physical connection with the state, and it is not at all clear that it ought to be subject to income taxation there. Consider, for example, a catalogue-sales business that sells a high percentage of its goods in a certain state. This business might be liable for substantial amounts of income tax under standard apportionment rules, and yet its activities within the state – consisting of little more than the use of the delivery services of other companies, themselves already physically present and taxable in the state – would be so minimal that these tax liabilities would be grossly disproportionate to the burdens that its activities impose on state and local governments. On the other hand, the sale of certain types of tangible goods might in some cases entail more than the minimal degree of physical presence that one associates with mail-order sales. (For instance, a company might sell heavy industrial equipment or hazardous materials, the delivery of which disrupts the normal flow of transportation.) Arguably, then, the case for using the sales of *tangibles* to establish nexus

for state corporate income taxation is stronger than for the case of intangibles.

Since the argument for nexus based on the sales of tangibles is less clear-cut than for the case of intangibles, it is perhaps appropriate that that issue has been decided by Federal statute, specifically, by PL 86-272. In this statute, the Federal authorities have [18] evidently decided that the balance of considerations favors a freer flow of interstate trade and a limitation of the taxing powers of the states. This decision is certainly consistent with the economic policy considerations presented above. In view of this decision at the Federal level, it would certainly be anomalous and inconsistent for states to base nexus on the fact that a corporation derives revenue from the licensing or sale of *intangibles* where it would not, by statute, have nexus if it were selling *tangibles*. By the same token, whereas conflicting considerations in the case of tangibles may warrant the resolution of the nexus issue by Federal statute, there are no such conflicting considerations in the case of intangibles. It is appropriate for the taxing powers of the states to be restricted, on constitutional grounds, by prohibiting them from taxing corporations that are not physically present within their jurisdiction. Doing so would contribute conceptual clarity to the definition of the taxing powers of the states in a way that would appropriately guide the decisionmaking of lawmakers at both the Federal and state levels and that would reduce the uncertainty about future tax policy that the private sector otherwise faces.

APPENDIX I

[19] Sources of Federal, State, and Local Government Revenue

Different levels of government in the United States have quite different structures of taxation. These reflect, in part, the differing economic functions of each level of government and the forces that constrain and shape policy at each level. A brief summary of some of the salient differences between Federal, state, and local governments is instructive.

The Federal government derives the bulk of its revenue from the direct taxation of individuals through the personal income tax and the payroll tax for social security; in recent years, these sources have accounted for about 80% of Federal revenue. The Federal government has also raised more than 10% of its revenue from corporation income taxes. By comparison, Federal excise taxes (some of which, like Federal taxes on fuels, may be viewed as a form of user fee or charge) account for less than 5% of Federal revenues. The Federal personal income tax has had a relatively progressive structure of marginal and average tax rates, with substantial personal exemptions and marginal rates that have often exceeded 35%.

States and localities, by contrast, rely much more heavily on charges, fees, licenses, and other similar sources of revenue to finance their activities. In recent years, these have accounted for around 23% of own-source revenue (or almost 20% of state and local revenue from all sources). States and localities also utilize individual income, sales, and property taxation as major sources of own-revenue, though at average and marginal rates far lower than those of the Federal government. Note that

charges, licenses, and other revenues are roughly *ten times* the amount of revenue collected from the corporation income tax at the state and local level, whereas, at the Federal level, corporate income tax revenues are roughly twice as large as those obtained from excise taxes.[9] These simple summary statistics reveal clearly that the states and localities rely much less heavily on corporation income taxes and much more heavily on charges, fees, and other similar revenue sources than does the Federal government.

The revenue structures of the states and localities reflect the fact that they provide [20] many goods and services for which it is possible to collect revenues (directly or indirectly) from beneficiaries. Many of the charges and licensing fees collected by states and localities are assessed against businesses, illustrating that the corporation income tax is only one of several means – and, of those, not the most attractive – by which states and localities can collect revenue from businesses. Fiscal competition at the state and local level has thus led to a relatively high degree of matching of revenue sources with the service-provision burdens that households and firms impose on the public sector and with the benefits that they derive from public-sector services. The Federal government, on the other hand, imposes taxes for which the match between benefits and burdens is much weaker. Indeed, a primary purpose of many Federal fiscal policies is precisely to create

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[9] Although it is often formally described as a general revenue source, the local property tax also clearly functions substantially as a charge for locally-provided goods and services, accentuating the role of price-like revenue instruments in the structure of state and local finance.

a mismatch between benefits and costs, i.e., to redistribute resources from some individuals in favor of others. These basic observations illustrate how the allocative efficiency functions and redistributive functions of the public sector play very different roles at the Federal and subnational levels of government in the United States, as the normative principles of fiscal federalism, outlined in Section II, suggest ought to be the case.

APPENDIX II

Public Service Provision Burdens

By Expenditure Function and Business Type

Functional Categories of Public Expenditure (% of State/Local Expenditure, for NC and for US, 1994--95)	Business Physically Present		Business Not Physically Present	
	Corporate	Non-Corporate	Corporate	Non-Corporate
Direct General Expenditure:				
Health, Education, and Welfare[1] (55.7, 50.8)	Yes	Yes	No	No
Highways (6.0, 5.7)	Yes	Yes	No	No
Air Transportation (0.4, 0.6)	Yes	Yes	No	No
Parking facilities (0.0, 0.1)	Yes	Yes	No	No

Functional Categories of Public Expenditure (% of State/Local Expenditure, for NC and for US, 1994--95)	Business Physically Present		Business Not Physically Present	
	Corporate	Non-Corporate	Corporate	Non-Corporate
Sea and Inland Port Facilities (0.1, 0.2)	Yes	Yes	No	No
Transit Subsidies (0.0, 0.0)	Yes	Yes	No	No
Police Protection (2.9, 3.0)	Yes	Yes	No	No
Fire Protection (1.0, 1.3)	Yes	Yes	No	No
Correction (3.2, 2.7)	Yes	Yes	No	No
Protective Inspection (0.4, 0.5)	Yes	Yes	No	No
Natural Resources (1.4, 1.1)	Yes	Yes	No	No
Parks and Recreation (1.2, 1.3)	Yes	Yes	No	No
Housing and Community Development (1.2, 1.6)	Yes	Yes	No	No
Sewerage (1.3, 1.7)	Yes	Yes	No	No
Solid Waste Management (1.3, 1.1)	Yes	Yes	No	No

Functional Categories of Public Expenditure (% of State/Local Expenditure, for NC and for US, 1994--95)	Business Physically Present		Business Not Physically Present	
	Corporate	Non-Corporate	Corporate	Non-Corporate
Financial Administration (1.1, 1.7)	Yes	Yes	No	No
Judicial and Legal (1.2, 1.4)	Yes	Yes	No[2]	No[2]
General Public Building (0.5, 0.5)	Yes	Yes	No	No
Other Governmental Administration (1.0, 0.8)	Yes	Yes	No	No
Interest on General Debt (2.4, 4.2)	Yes	Yes	No	No
Miscellaneous Commercial (0.0, 0.0)	Yes	Yes	No	No
Other and Unallocable (3.4, 4.4)	Yes (?)[3]	Yes (?)[3]	No	No
Other Direct Expenditure:				
Utility Expenditure (8.3, 6.7)	Yes	Yes	No	No
Liquor Store Expenditure (0.7, 0.2)	No	No	No	No

Functional Categories of Public Expenditure (% of State/Local Expenditure, for NC and for US, 1994--95)	Business Physically Present		Business Not Physically Present	
	Corporate	Non-Corporate	Corporate	Non-Corporate
Insurance Trust Expenditure (5.3, 7.9)	Yes	Yes	No	No

Source: US Bureau of the Census

1. Total of expenditures for education, libraries, welfare, hospitals, health, and social insurance.
2. Other than contingent.
3. Insufficient information.

APPENDIX J

Economic Analysis of North Carolina Administrative Rule .0102

By

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Introduction

I have been asked to examine the economic effects of Administrative Rule (Ad. Rule) .0102 of Chapter 5 of Title 17 of the North Carolina Administrative Code, as amended November 2, 1992 (copy attached). In performing this analysis I draw upon standard economic models of state governments that have been published by top economists in leading economics journals (see e.g., Maloney, McCormick, & Tollison, 329). These models predict that state governments will seek, when possible, to export the incidence of taxes to nonresidents and to use taxes to shield in-state economic interests from competition with out-of-state businesses. I have written several published articles that have dealt with regulation of milk through state milk commissions, including the North Carolina Milk Commission. This work and other articles I have studied have led me to the conclusion that state governments enact laws and regulations even though they are aware that these laws have a high probability of being declared unconstitutional under the Interstate Commerce Clause of the U.S. Constitution. Given these tendencies, it is imperative that the courts fashion clear and unambiguous rules that are easily understood by both states and affected businesses.

[2] Ad. Rule .0102 is an example of a regulation that exports state income taxes to nonresidents. Not only does Ad. Rule .0102 tax entities that have no physical presence in the state of North Carolina, but the potential reach of the regulation is so broad that it creates substantial economic uncertainty. The combination of Ad. Rule .0102 and PL 86-272 creates economic distortions because of the difference in tax treatment between tangible and intangible property. PL 86-272 insulates sellers of tangible property from the tax jurisdiction of the state of North Carolina while licensors of intangible property, with no physical presence, would be subject to income tax under Ad. Rule .0102. My conclusion is that the physical presence rule works well for sales of tangible property and should apply also to licensing of intangible property. The physical presence rule promotes economic efficiency by making legal constraints certain and easily understood.

Finally, I discuss specialization and the economics of licensing and franchising. I show that the creation, maintenance and enhancement of the value of the trademarks take place entirely outside the state of North Carolina. The only connection that the trademark protection company has with North Carolina is measurement of the amount of the royalty. In the last part of the paper I show that the trademark protection company (TPC) does not do business in the state of North Carolina.

I. Economic Analysis: A Proven Track Record of Predicting

Economics is the study of choices people and institutions make when there is scarcity. Economists make a few assumptions such as, that wants are unlimited, but that

the resources to satisfy these wants are limited. Using the laws of supply and demand, Adam Smith and others have likened pursuit of self-interest to an "unseen hand" that [3] provides for the common good (Smith, 423). Economics has been a very successful social science in predicting behavior of consumers and firms. Demand studies are able to predict consumer response to a price change within a small range. Huge economic models have been developed to predict a whole host of seemingly unrelated economic phenomena such as the impact of the international trade deficit on domestic automobile sales. Economic models have also been developed to estimate the impact of government regulation. For example, economists predict that price supports for agricultural products will result in surpluses of the products supported. Although economic models may at times fail to forecast macroeconomic downturns, microeconomic models have been very successful (Samulson, 47). I am using a microeconomic analysis of the actions of state governments.

A. Law and Economics

During the last 30 years a subdiscipline within economics, law and economics, has contributed much to our understanding of politics, crime, products liability and race relations.[1] Law and economics scholars have developed economic models appropriate for analyzing governments, including state governments. Richard Posner, a leading scholar in law and economics, has written the following about state governments,

> Each state has an economic incentive to impose taxes whose burden will fall, so far as possible, on residents of other states. Such an incentive is undesirable. It not only deflects the state from

> the search for taxing methods that maximize efficiency and distributive criteria for the nation as [4] a whole; it also leads to socially excessive government expenditures, by enabling the state to externalize the costs of its public services. States may also use taxation not to raise revenue but to protect the state's producers or other sellers from competition of nonresidents. Such a tax will harm resident consumers as well as nonresident sellers of the out-of-state goods that are taxed – and indeed the loss to the resident consumers will usually exceed the gain to the resident sellers (Posner 1986, 602).

Maloney, McCormick, and Tollison, in their article, "Economic Regulation, Competitive Governments, and Specialized Resources," proposed to extend the economic theory of state government regulation by testing the assumption that politicians will seek to raise revenue from out-of-state sources, "where these costs are least for any given level of output restriction. In minimizing these costs, the political process will generally subordinate the interests of foreigners [out-of-state interests] to those of citizens in the local polity." (Maloney, McCormick, & Tollison, 329).

A large number of other works could be cited. The message from economists who have studied state governments is clear. State governments act similar to most for-profit firms. When they have an opportunity to obtain tax revenue at low costs politically, such as taxing out-of-state interests, they will levy such taxes unless there are clearly defined legal constraints that prohibit such conduct. The flip side of this issue is that state governments will protect in-state economic interests at the expense of out-of-state sellers and at the expense of in-state consumers who are not as well organized politically.

[5] B. Economic Origins of the United States

Even as early as the birth of our country, economists were aware of the potential for mischief when government and business leaders get together. Adam Smith noted in 1776 in his book THE WEALTH OF NATIONS that, when business and government leaders get together for lunch, it is usually at the public expense. Victory over the British was followed in the fledgling United States by a loose confederation of state governments that reflected a fear of strong central governments. The Articles of Confederation, however, quickly proved to be unworkable because of the predictions of the economic model of state governments. As noted by Posner, state governments would favor in-state business interests by imposing taxes on out-of-state products coming into the state. The viability of the United States as a country was threatened by parochialism of state governments.

Although some scholars disagree on the significance of taxes imposed by one state on another's goods, it was a nagging problem that was rectified decisively when the U.S. Constitution was ratified (McLaughlin, 68). It was not an accident that when the Constitution was ratified responsibility for regulating interstate commerce was delegated to the federal government. In *Quill* the U.S. Supreme Court flatly stated, "Under the Articles of Confederation, state taxes and duties hindered and suppressed interstate commerce; Framers intended the Commerce Clause as a cure for these structural ills."[2] Unless state governments could be prevented from discriminating against out-of-state business interests, the country would have broken up into separate country-states. In spite of the Commerce Clause in the U.S. Constitution, early challenges to the authority [6] of the

federal government were posed in *Gibbons v. Ogden* when New York demanded that ships crossing New York state lines obtain a license from New York authorities in order to transport people.[3] A host of other cases could be cited that are based on attempts by state governments to export taxes to nonresidents or protect in-state economic interests from interstate competition.

C. An Application of the Model: Milk Regulation

My Ph.D. dissertation in economics at the University of Virginia was entitled, "Federal Regulation of the Dairy Industry: Costs, Benefits and Legal Constraints." In subsequent work on the law and economics of the dairy industry I received grants by the U.S. Department of Agriculture, the Agricultural Research Service of the State of North Carolina and the National Science Foundation. In some of this work I examined state milk commissions. In state after state, milk commissions concocted some of the most complicated regulations imaginable, but the net economic effects were always the same. In-state milk producers, cooperatives and dairy farmers, were favored at the expense of out-of-state dairy interests (Baumer, 33). Milk commissions in various states were challenged successfully in federal and state courts and virtually all were declared unconstitutional under the Interstate Commerce Clause (see Table 1 in Appendix 1).

In several instances, following the declaration of unconstitutionality of the milk commission in a nearby state, state milk officials modified their milk regulations to try to avoid constitutional challenges in their state. State milk officials were very aware that their regulations most likely violated the Commerce Clause and yet they

continued to fashion regulatory subterfuges to evade the clear rulings of the courts. North Carolina [7] was among the last states to have a state milk commission and persisted in enacting unconstitutional milk regulations that raised the price of milk imported from Virginia and Tennessee so that a greater share of the milk consumed in North Carolina was produced in-state.[4] The actions of state governments with respect to milk regulation were accurately predicted by Posner's model of state governments. It is also important to note that large delays, substantial legal expenses, and higher milk prices took place until these milk commissions were eliminated by court rulings.

The lesson from the milk cases and other cases involving the interstate commerce clause is that the protective tendencies of state governments for in-state economic interests must be met by clear, unambiguous rules. In the case of milk the courts held that if state milk regulations raised the price of out-of-state milk, the regulation was unconstitutional. The same principle applies with equal force to tax jurisdiction. Unless state governments are confronted with clear, unambiguous rules they will enact tax rules that tax out-of-state interests.

II. Well Defined Legal Constraints Enhance Economic Efficiency; Ambiguous Rules Create Inefficiencies

A. A Nexus within the State Should Require a Physical Presence. Otherwise there Are Substantial, Negative Economic Consequences.

Imagine an outfielder in major league baseball. A ball is hit deep in the outfield near the outfielder and he

rapidly moves back towards the outfield wall. The ball starts to descend, the outfielder jumps and makes a terrific catch depriving the batter of a home run. The *efficiency* with which major leaguers patrol the outfield brings in fans by the [8] thousands. The outfield wall is a *constraint* that is certain and unforgiving, and yet major league players run to the brink of these walls to retrieve flying balls, and make it look easy.

On the other hand, there are some situations in which baseball players, even major leaguers, can look downright foolish. *Inefficient* play frequently occurs when a ball is hit short in the outfield between an infielder and the outfielder. There is a scramble by both the infielder and outfielder as to who will catch the ball. Since both the infielder and the outfielder have their eyes on the flying ball, they cannot see each other. They can yell, "I got it" but there is not a lot of time for conversations if both players make the same claim. Coupled with fan noise, signals between the infielder and outfielder often break down. The ball, which is easily catchable by either player, often falls between the two as they glare at each other. Just as often the players collide. The reason for these snafus is that the *constraints* are not well defined.

These two scenarios are a metaphor for economic activity. In the first scenario, there is a well-defined constraint, the wall, and the outfielder performs masterfully within the constraints. In a market economy, firms operate within constraints and economists have called this process, *constrained optimization.* Firms optimize profits within price and cost constraints. Since most firms are too small to significantly affect market prices, the market price is a constraint. Firms adjust their level of output according to market prices received for their products.

Economic theory predicts (and the prediction has been tested thousands of times) that firms will continue producing as long as their incremental costs are less than the incremental revenue they receive on their last unit of production. Firms are constrained by both prices and their level of technological development, which [9] determines their cost structure. Changes in either will cause firms to change their level of output.

B. Well Defined Legal Constraints

When constraints are not well defined, economic efficiency is lost. Confusion between the outfielder and infielder occurs because it is not clear where the constraints are. When prices and costs are highly variable, firms have to take insurance measures to guard against unexpectedly low prices or higher than expected costs. Property rights create legal constraints that also affect firm behavior. When legal constraints are well defined firms can operate efficiently just as an outfielder in major leagues. When legal constraints are imprecise and ambiguous, firms have to devote resources toward clarification of their rights. The legal constraint against theft is well established, and therefore firms can spend most of their resources producing products rather than guarding against theft. If there were no enforceable legal constraints against theft, firms would have to devote much more of their resources towards theft avoidance. Clear, unambiguous laws against theft enhance economic efficiency.[5]

In economic models, the costs associated with negotiating and enforcing contracts are often assumed to be zero and the focus is upon prices, quantities, and quality of the

products being sold. There is, however, significant recognition by economists of the costs of contracting and the costs of clarifying property rights. Economists label the costs "transaction costs." According to economists, laws should be as unambiguous as possible, otherwise firms will expend resources seeking advantages through the law rather than producing better products. As stated by Cooter and Ulen, "One well-[10]confirmed result in the literature on bargaining is that bargainers are more likely to cooperate when their rights are clear, and less likely to agree when their rights are ambiguous." Continuing the same theme, authors state what virtually all economists agree with that, "successful bargaining generates a cooperative surplus, or, as a fundamental theorem of welfare economics puts it, voluntary exchange is mutually beneficial."[6] The authors are discussing contractual bargaining but the importance of unambiguous legal rights is more general. Hirsch indicates that the same principles apply to property rights. "The presence of property rights furnishes incentives to use resources efficiently. Given a legal system that enforces property rights, holders can have confidence that they will obtain returns from the use of property" (Hirsch, 25).

In the third edition of Richard Posner's book, ECONOMIC ANALYSIS OF LAW, he states in Chapter 3 under The Economic Theory of Property Rights, ". . . legal protection of property rights creates incentives to use resources efficiently." At Section 3.2 Posner discusses the consequences of lack of clear property rights in connection with such issues as, "Wild Animals, Treasure Trove, Intellectual Property, Privacy, and Other Exotica." According to Posner, when the costs of enforcing property rights become too high relative to the benefits, property rights

are left undefined. In primitive societies, rights to wild animals are not established in part because they would be too difficult to enforce. As society develops, property rights to domesticated animals are recognized and these rights lead to efficient use of animals. In contrast, when property rights are not established, such as the rights to hunt or fish wild animals, over hunting and over fishing, even to the point of extinction, are the result. Whales, beavers, and seals come to mind.

[11] Other examples of excessive expenditures on transaction costs are well known. The federal government owns huge areas of land in the West. A number of interest groups bargain through the courts and before various regulatory bodies (federal and state) to acquire or maintain a myriad of property rights. Lumber companies compete with environmentalists and ranchers for the right to harvest trees. Environmentalists have latched on to the Endangered Species Act to hold up commercial development of forests. In many areas water rights and grazing rights are owned by farmers and ranchers and are priced below market rates. In order to maintain these grandfathered rights, farmers and ranchers have to attend regulatory hearings and make the case for their interests. This tremendous expenditure of resources is noticeably absent when land is privately owned and property rights are clear.

Another source of legal ambiguity is changes in the law. An important function of the law is to facilitate planning and that goal is frustrated when regulatory changes are numerous. The legitimate expectations of the parties are defeated when new regulations change basic legal constraints. In egregious cases there is compensation for regulatory takings, but when the taking is partial

there is no compensation. The common law system facilitates continuity while accommodating gradual change. "Viewed economically, the body of precedents in an area of law is a stock of capital goods—specifically, a stock of knowledge that yields services over many years to potential disputants, in the form of information about legal obligations." (Posner, 509). On the other hand, rulings of administrative agencies that frequently change are a source of inefficiency.

[12] **C. The Physical Presence Rule Is easily Determined by Businesses and by State Officials. It is a Well Defined Legal Constraint.**

The precedents surrounding the imposition of tax jurisdiction by state officials over out-of-state interests were, until recently, clearly defined. An out-of-state business was not subject to state tax jurisdiction unless there was a physical presence within the state. The quid pro quo was that an out-of-state business interest was subject to the jurisdiction of the state if it maintained employees, property, or some other physical contacts with the state. Many of the cases that created the bright line between those businesses subject to a state's jurisdiction (and those not) involved mail order companies. The clear demarcation as to when a state could impose tax jurisdiction enabled businesses to avoid inadvertent impositions of taxation. With the easily determinable boundary, indeed a wall, both businesses and states could plan. Well-defined rules regarding jurisdiction enabled states to estimate their revenue and enabled businesses to know that taking certain actions entailed becoming subject to state tax jurisdiction.

The economic principles of constrained optimization work well when the constraints are defined clearly.

D. Battles as to Whether Other, Ephemeral Connections with a State Constitute a Nexus Are a Waste of Resources.

The slender reed upon which the NC Department of Revenue places its jurisdictional claim over the trademark protection company (TPC) in Delaware creates economic uncertainty. If firms are told that basing royalties on gross sales volume in North Carolina causes the trademark protection firm to be subject to income tax, then firms will base their royalties on some other criteria. There may be a lot of unnecessary [13] and wasteful maneuvering and litigation by firms seeking to avoid income taxation of trademark protection companies by restructuring the licensing agreement.

In a very abstract sense intangible property in favor of a licensor is created in the form of an account receivable if its licensees remit royalties based on sales volume in North Carolina. When a plumbing supply company located in Florida sells copper pipe to a North Carolina plumber and the pipe is transported by a common carrier, an account receivable is also created in North Carolina in favor of the Florida plumbing company unless the pipes are paid for in advance or it is a C.O.D. sale. In both cases an account receivable is created and yet one company could be subject to income tax in North Carolina while the other is not. The profits of the Florida company are subject to income tax in Florida, if it has one.

According to Sports Illustrated, in the not too distant future, most major sporting contests, such as the World

Series in baseball, will be pay-TV events. Suppose in 2001 that the Atlanta Braves again play in the World Series. Turner Broadcasting Company will undoubtedly license cable pay-for-view companies in North Carolina to enable North Carolina customers to watch the Braves play in the World Series. The royalties remitted by the cable companies to the Atlanta Braves will be measured by the number of customers in North Carolina. To make this example crystal clear, the licensor is the Atlanta Braves and the licensees are the cable companies, selling a product to North Carolina customers. The structure of the transaction is virtually identical to the instant situation in which a TPC performs services for which the licensees remit royalties based on dollar volume of sales in North Carolina. The economic value of the Atlanta Braves and their fan appeal are based on actions and decisions that take place outside the state of [14] North Carolina. Since the Atlanta Braves never play baseball in North Carolina, the nexus with the state under the Interstate Commerce Clause is simply insufficient. North Carolina should not be able to impose income tax on an organization whose only exposure to the state of North Carolina is through pay-TV, cable hookups. This example shows the illogical consequences of seeking to impose income taxation on vendors based on contact with their customers.

Other examples could be imagined in which the structure of the transaction is similar to the instant situation, but the imposition of income tax by the state of North Carolina is inappropriate and inefficient. Cal Ripken works for the Baltimore Orioles located in Maryland. He autographs baseballs and licenses apparel companies to put his well-recognized image on clothes and shoes. The royalties remitted to Mr. Ripken by vendors of

baseball collectibles and clothing manufacturers increase every time a sale is made to a North Carolina customer. To my knowledge, Cal Ripken has no on-going business activity in the state of North Carolina other than the activities described above which are due to his sportsmanship and stamina, which has been cultivated *at Baltimore and other non-North Carolina locales.* I think that Cal Ripken should not have to complete North Carolina income tax forms based on sales of his endorsed products in North Carolina.

E. Ad. Rule .0102 Harms the Economy of North Carolina if Other States Reciprocate.

Much of my current research deals with high-tech firms and management of technology (Baumer et al., 1998a & 1998b). In addition, I teach a graduate course to [15] management and engineering students entitled, BUS 504 **Technology, Competition and the Law**. There is no doubt that North Carolina, especially in Research Triangle Park, is one of the most technologically advanced areas in the world. A huge amount of intellectual property has been amassed in North Carolina in the form of patents, copyrights, and trademarks. Most of this intellectual property is licensed to out-of-state firms who make sales to customers in other states. To date, because most of these high-tech firms do not have a physical presence in other states, they pay most or all of their income tax to the state of North Carolina. Enactment and application of regulations like Ad. Rule .0102 by other states might create a net deficit of tax revenue in North Carolina because of its high-tech superiority. In addition, complying with the tax

requirements of a large number of states would retard and possibly thwart the growth of very small, high-tech firms that have the greatest potential for growth.

F. Those who do not Learn from History Are Destined to Repeat Historical Mistakes.

An important worldwide economic phenomenon is the slow, but seemingly inexorable, progress among the European nations to merge their economies. The inefficiencies associated with allowing small countries to erect trade barriers, dump surpluses and export taxes are evident to both ordinary European citizens and their political leaders. In spite of long held nationalist sentiments, economic gains from removal of trade barriers provide the impetus for continued economic integration in Europe. The most recent major step in this process has been adoption of a single currency, the "euro". According to Professor Charles Wyplosz at the Graduate Institute [16] of International Studies in Geneva, Switzerland, "The direct benefits [of European monetary union] come in the form of reduced transaction costs and reduced uncertainty, possibly including additional transparency in competition." (Wyplosz, 19). Professor Flam, of the Institute for International Economic Studies in Stockholm, Sweden speaking of full economic integration is even more direct. According to Professor Flam, "Theory predicts many positive and few negative effects from the '1992' measures in qualitative terms. Whether these will translate to substantial quantitative gains, depends on the size of the reductions in trade barriers and the extent to which the measure will be implemented." (Flam, 27).

Citizens and leaders in the newly created United States following the Revolution became aware of the potential for mischief if the states were allowed to erect trade barriers. Citizens of various states in the United States during the last part of the 18th Century did not have centuries of animosities to overcome when responsibility for regulating interstate commerce was delegated to the federal government. Nevertheless, the union of the United States could not have been maintained without eliminating the right to erect trade barriers, export taxes and do other activities that give advantages to in-state economic interests.

The struggle to maintain complete economic union among the United States is continuing. On one point, however, there is clear agreement: the United States has no desire to allow the states to be balkanized. The European Union is devoting a huge amount of resources to achieve what we have in the United States. They are moving towards us, not the reverse. Ad. Rule .0102 and its ilk are clearly contrary to the spirit of economic integration among the states. These types of tax regulations are attempts to [17] extend state jurisdiction beyond state borders and are the type of tax regulations that are normally enacted only by sovereign countries. It is important to nip in the bud these atavistic attempts to return to the bad old days of the Articles of Confederation. If the States are allowed to fashion tax rules and laws that levy taxes on out-of-state entities, a slippery slope exists that could plunge us back towards what the Europeans are trying to eliminate. The price of economic freedom is eternal vigilance against state-enacted tax rules that are fashioned to enable states to tax entities that have no physical presence within the state.

III. Economic Distortions Are Greatest when Dissimilar Tax Treatment Is Accorded to Similar Products.

According to economists, taxes should be allocated so as to minimize interference with consumer choices. Musgrave and Musgrave list five characteristics of a "good" tax structure. In addition to tax equity and raising stable tax revenue, the authors state that a "good" tax structure "should be chosen to minimize interference with economic decisions in otherwise efficient markets." (Musgrave and Musgrave, 193). This objective is often referred to as tax neutrality. The authors also contend that, "[t]he tax system should permit efficient and nonarbitrary administration and it should be understandable to the taxpayer." Finally, "[a]dministrative and compliance cost should be as low as is compatible with the other objectives." Using the economic criteria suggested by the Musgraves and employed by most economists, I find that Ad. Rule .0102 fails the economic test on three of the five criteria listed by the Musgraves.[7]

[18] A. Economic Distortions

Economists classify tax burdens as direct and excess. The direct burden of taxes is the transfer of income from taxpayers to the government. The excess burden, sometimes called the deadweight loss, is a measure of the additional costs of taxes (Musgrave, 455).[8] Quantifying the excess burden of taxes entails measuring changes in producer and consumer surplus created by taxes. For example, taxing butter but not margarine would not only generate tax revenue from butter customers but also would raise butter prices and cause marginal butter consumers to switch to margarine. Presumably, before the

tax and the resulting price increases, some consumers preferred butter but were induced by the changed prices to switch to margarine. The economic losses associated with these switches are the excess burden.

The "goodness" of taxes in terms of economic efficiency is typically measured by economists as the relative size of the excess burden. Generally broad taxes have smaller excess burdens because they do not disturb relative prices among goods. On the other hand, selective taxes on particular products are characterized by high excess burdens. In mathematical terms the excess burden is equal to $\frac{1}{2}(Et^2PQ)$ where E is the price elasticity of demand for the product, t is tax rate, P is price and Q is quantity. The greater the price elasticity is, the greater the excess burden. If a product has close substitutes its price elasticity will be greater, *ceteris paribus,* and thus dissimilar tax treatment for similar products will create the greatest economic inefficiencies.

B. Conflicts on the Horizon

[19] Technological advances have facilitated other ways of making sales. A number of cable channels conduct sales based on displays of products over the airwaves accompanied by phone numbers and email addresses. Does Ad. Rule .0102 enable the state of North Carolina to tax the income of sellers of products displayed on cable shopping channels? Tax decisions of the revenue department will become increasingly arbitrary because there is no way to tax every business or celebrity that exposes themselves in some way to customers in North Carolina. The disparity in tax between mail order sales and trademarked retail sales will be difficult to justify to taxpayers. Again, the

legal confusion could be cleared up by adherence to the physical presence rule. It is a rule that makes economic sense for tangible products and should apply to intangible transactions as well.

IV. The Economics of Franchising

Adam Smith was among the first economist to note that specialization is limited by the size of the market. When a market becomes very large it makes sense for firms to specialize in performing value-adding tasks in order to realize economies of scale. In very small firms, the entrepreneur must be a jack-of-all-trades, having a keen awareness of finance, marketing, production, and human resource management. As firms get larger these tasks are allocated to separate divisions and even separate affiliated companies. Among retailers, licensing and franchising has become increasingly prevalent.[9]

A. Enhancing the Value of the Trademark

[20] TPCs have two basic tasks: legal protection of the trademarks and monitoring of the retail stores for quality control purposes. The trademarks are generally protected legally with the assistance of a specialist in intellectual property law. Economic models of specialization suggest that creating a separate trademark protection company would enable companies to better manage their investments in trademarks. In terms of legal protection, a separate TPC frees management at the individual stores from being distracted by infringement litigation.

The legal value of a trademark is based on two factors: the strength of its legal protection and the secondary

meaning the trademark engenders among customers. Aspirin, parachute, and trampoline are all former trademarks whose legal protection was eroded and eventually destroyed as those terms became generic. In other cases, failure to promptly pursue infringers has resulted in diminished value of the trademark and dilution. In order to prevent dilution, the McDonalds Company will pursue any company that prefaces its products with "Mc" and the Disney Company will not tolerate unauthorized use of its cartoon characters such as Mickey Mouse.

A number of economists have examined the economics of franchising (and licensing) (Klein & Saft, Dnes). The predominant economic view of franchises (and licenses) is that the franchisor (or licensor) provides unique services to franchisees (or licensees) by preventing free riding on quality.

> "The essential aspect of a franchise distribution arrangement is the creation of a standardized product . . . Because the quality information applies to a group of franchisees using a common name, there is a free-[21]riding problem. If each franchisee supplies inputs that significantly influence the quality of the product marketed, and consumers cannot detect the quality of the product before they purchase it, then each franchisee will have the incentive to cut costs and supply less than the desired level of product quality." (Klein and Saft, 349).

Given the incentive of franchisees (or licensees) to free ride, monitoring for quality is a task allocated to franchisors (licensors). In the case of the Limited TPCs, monitoring for quality control takes place pursuant to steps called for in the licensing agreement (1995 New York Tax Lexis

493, 24). Quality-control monitoring enhances the value of the trademarks, which is the other major task of the TPC. Both of the major tasks of TPCs that are discussed in the law and economics literature, legal protection and quality control, are accomplished outside the state of North Carolina.

B. Measuring Royalties

Dnes investigated franchise licensing agreements and royalty payments among some of the major franchises in the U.S. (383). Dnes agrees with the economic view of franchises propounded by Klein and Saft that a primary task of licensors is monitoring of quality. The primary focus of the Dnes study was examination of the royalties and the incentives alternative structures of payments create. In Dnes' view (and the view of most economists) there are two perverse incentives associated with franchises. The first is the free rider problem by licensees, discussed immediately above. The other perverse [22] incentive is contrived forfeitures of the franchise by opportunistic licensors who want to take advantage of successful licensees. According to Dnes,

> The case studies typically reveal a modest lump sum with most of the franchisor's income arising on a profit-sharing, sales-royalty basis. As sales are likely to be closely linked to the franchisor's centralized efforts, the use of a sales royalty rather than an explicit profit share need not imply incentive incompatibility.[Fn. omitted]. A straightforward explanation of the use of sales royalties may be that the franchisee's profits are difficult to audit as the franchisee can inflate his costs by creative accounting. In contrast, sales figures are easier to observe and verify.

The bottom line is that basing royalties on sales is only used because disguising profits by franchisees (or licensees) is so difficult to detect and prevent. If franchisee's profits were transparently obvious to the franchisor, profits, not sales would be used as a basis for measuring the royalty. *It is vitally important to keep in mind that sales-based royalties are simply a measuring device because profits are difficult to identify.* The Limited TPCs are not in the business of selling clothes in North Carolina. They are in the business of protecting the value of trademarks outside the state of North Carolina.

[23] Conclusion

State governments have a legitimate right to tax citizens and businesses that are physically present and benefit from the enforcement laws within the state. Under the U.S. Constitution they do not have authority to tax businesses located out-of-state unless there is a substantial nexus with the state. As technology and communications improve states are becoming more inventive in their attempts to establish nexuses between themselves and business entities whose connections with the states are increasingly ephemeral. Economists who have studied the issue agree with statutes and court rulings that have been developed to curb the acquisitive instincts of state governments. Without unambiguous constraints on the power of state governments to levy taxes, history shows us that state governments expand their taxing authority to inefficient levels. The fact that the federal government has a constitutionally delegated power to regulate interstate commerce shows anew the wisdom of the Founding Fathers.

Without court rules that enforce the delegation of authority to regulate interstate commerce to the federal government, and limit state interference with interstate commerce, the U.S. would descend into the chaos that characterized the aftermath of the Revolution against England. Europe is in the painful process of trying to undo the trade restraints and taxing anomalies that have been largely absent in the U.S. Ad. Rule .0102 is an unwise, major step back toward Europeanized relationships among states. If all states enacted similar rules, regulatory and economic chaos could result because there would be an unsustainable scramble to tax the same income. Extraterritorial attempts at taxation by states create a negative sum relationship among states and reduce the overall level of national economic activity. The ultimate irony is that if all states enacted such [24] rules, North Carolina would be harmed because it possesses a comparative advantage in accumulation of intellectual property. Administrative rules like .0102 from other states would cause the high-tech software and biotech firms located in Research Triangle Park and other places in North Carolina to pay significant shares of their income to other states.

A rule that has functioned well in limiting the reach of state governments is the physical presence rule. It is an unambiguous rule that informs the parties of the consequences of their actions. If Ad. Rule .0102 is allowed to stand, the exempt status of mail order companies (from having to collect state sales or use taxes) would be in marked contrast to allowing a state to tax the *income* of a firm that had no physical presence and virtually no contact with the state of North Carolina. Clearly, mail order companies have more contact with and derive more benefits from the host state than trademark protection

companies whose only contact with the state is a contract with the licensee. Ad. Rule .0102 makes new technologies such as cable sales and Internet opportunities subject to a great deal of economic uncertainty. Large amounts of resources will be expended trying to decide whether various possible connections with the state of North Carolina are sufficient for taxing of income of those entities. The economic uncertainty could be eliminated by adherence to the physical presence rule.

The Delaware trademark protection company protects a highly valuable intangible product. Protection of the trademark has been achieved through several management actions that have proven highly successful. The actions taken by the Limited are consistent with economic studies of licensing. By protecting the value of Limited's trademarks, the Delaware TPC is not "doing business" in North Carolina. Royalties are [25] measured by gross sales in North Carolina and other states only because profits are hard to determine. The royalties received by the Delaware TPC are earned pursuant a licensing agreement that calls for actions by the licensor that take place outside the state of North Carolina.

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Appendix: Table 1

	Current Regulation			Former Regulation	
State	**Type**	**Date**	**CFR No.**	**Provision ruled Unconstitutional**	**Date**
Alabama	Fed. Order	1981	1093	Requiremnt to Purchase from Ala. Base holder	1980
Florida	Fed. Order	1966	1012	Down allocation of out-of-state producers	1964
Georgia	Fed. Order	1969	1007	Entire Regulation	1968
Kentucky	Fed. Order	1962	1046	Prohibition on below cost pricing	1985
Louisiana	Fed. Order	1976	1096	Uniform Minimum Prices for out-of-state producers	1974
Mississippi	Fed. Order	1976	1094		
North Carolina	Fed. Order	1988	1005	Uniform Minimum Prices for out-of-state producers	1985
South Carolina	Fed. Order	1988	1005	Uniform Minimum Prices for out-of-state producers	1984
Tennessee	Fed. Order	1949	1011		
Virginia	State Milk Comm.	1934			

Source: Baumer, "Lessons from Deregulation of Milk Prices at the State Level." 2(2) *Journal of Pricing Management* 27, 1991.

[29] [1] Many economists date the beginning of law and economics to an article written by Ronald Coase, "The Problem of Social Cost", 3 *Journal of Law and Economics* 1 (1960). The article is the most widely cited in all of economics and Ronald Coase was awarded a Nobel Prize in economics. The "Coase Theorem" suggests that if property rights are clear and bargaining costs are low, economically efficient outcomes will result even though production or consumption by one party harms the other party.

[2] Quill Corporation v. North Dakota, 504 U.S. 298, 312 112 S.Ct. 1904, 1912 (1992).

[3] 9 Wheat. 1, 6 L.Ed. 23 (1824).

[4] The North Carolina Milk Commission had 10 members, 5 of who were dairy farmers.

[5] According to Werner Hirsch, LAW AND ECONOMICS, at 25, "The presence of property rights furnishes incentives to use resources efficiently. Given a legal system property rights, holders can have confidence that they will obtain returns from the use of property." At page 22 he states, "In summary, conflicts over property rights and entitlements are often resolved through the use of legal institutions. These conflicts can become severe when the property rights or entitlements are not well defined (i.e., when there are externalities present)."

[6] R. Cooter & T. Ulen, LAW AND ECONOMICS, at 100.

[7] Phillip Musgrave was chaired professor in public finance at Harvard University and Peggy Musgrave was an associate professor at Northeastern University in 1973 at the time of the writing of their widely used graduate textbook on public finance and taxation.

[8] Professor Arnold Harberger of the University of Chicago developed this approach which is widely used. See his, "Taxation, Resource Allocation and Welfare," in *The Role of Direct and Indirect Taxes in the Federal Revenue System,* Washington: Brookings, 1964.

[9] Kaufmann and LaFontaine report that 34 percent of all U.S. retail sales in 1988 were made by franchisees or licensees.

CORPORATE INCOME

ADMINISTRATIVE RULES

The following Administrative Rules, which pertain to corporate income tax, were issued by the North Carolina Department of Revenue, and are reproduced as amended to date.

See page 1351 *for a "Finding List of Administrative Rules."*

TITLE 17

DEPARTMENT OF REVENUE

Chapter 5

Corporate Income and Franchise Tax Division

Subchapter 5C

Corporate Income Tax

Section .0100 – Corporations Subject to the Tax: Tax Rate and Allocation

[¶ 14-001] .0101 **Domestic and Foreign Corporations Required to File.** – (a) A foreign corporation operating in North Carolina may be liable for income tax even if it is not required to obtain a certificate of authority to do business in North Carolina. For example, a Virginia corporation engaged in the general contracting business which obtains a single job in North Carolina to be completed within six months, would not, under the Business Corporation Act, be required to obtain a certificate of

authority to do business in this state but would be subject to income tax.

(b) Even for a year in which a domestic or foreign corporation conducted no business activity or did not earn any net income, it must file an income tax return.

(Added February 1, 1976; amended January 1, 1994.)

[¶ 14-004] .0102 **Doing Business Defined.** – (a) For income tax purposes, the term "doing business" means the operation of any business enterprise or activity in North Carolina for economic gain, including, but not limited to, the following:

(1) the maintenance of an office or other place of business in North Carolina;

(2) the maintenance in North Carolina of an inventory of merchandise or material for sale, distribution or manufacture, regardless of whether kept on the premises of the taxpayer or in a public or rented warehouse;

(3) the selling or distributing of merchandise to customers in North Carolina directly from a company-owned or operated vehicle when title to the merchandise is transferred from the seller or distributor to the customer at the time of the sale or distribution;

(4) the rendering of a service to clients or customers in North Carolina by agents or employees of a foreign corporation;

(5) the owning, renting, or operating of business or income-producing property in North Carolina including, but not limited to, the following:

(A) Realty;

(B) Tangible personal property;

(C) Trademarks, tradenames, franchise rights, computer programs, copyrights, patented processes, licenses.

(b) Corporations who are partners in a partnership or joint venture operating in North Carolina are considered to be "doing business".

(c) "Doing business" by an interstate motor carrier is defined as the performance of any of the following business activities in North Carolina:

(1) The maintenance of an office in the State;

(2) The operation of a terminal or other place of business in the State;

[1362] (3) Having an employee working out of the office or terminal of another company;

(4) Dropping off or gathering up shipments in the State. (Added February 1, 1976; amended November 2, 1992; January 1, 1994.)

[¶ 14-007] .0103 **Corporations Operating in Interstate Commerce.** – The fact that a foreign corporation's activities or operations in North Carolina are a part of its over-all interstate business does not exempt the corporation from income tax liability. A corporation doing business in North Carolina in any of the capacities outlined in Rule .0102 ("Doing Business" Defined) is subject to income tax even if its only operations in this state are a part of its interstate business. A foreign corporation not domesticated in North Carolina whose only activity in this state is the solicitation of sales by either resident or nonresident salesmen is not required, to file income tax

returns. However, if such a corporation maintains an office or other place of business in North Carolina, or if it owns business property in this state, it is subject to the tax.

(Added February 1, 1976; amended January 1, 1994.)

[¶ 14-010] .0104 **Tax Rate and Basis for the Tax. –**

(Added February 1, 1976; amended October 23, 1977; December 23, 1979; repealed October 31, 1981.)

[¶ 14-013] .0105 **Corporations Required to Allocate Income. –**

(Added February 1, 1976; amended October 23, 1977; December 23, 1979; repealed October 31, 1981.)

[¶ 14-016] .0106 **When in Doubt as to Liability. –**

(Added February 1, 1976; amended October 23, 1977; December 23, 1979; repealed October 31, 1981.)

[¶ 14-019] .0107 **Tax Forms Mailed to Taxpayer. –**

(Added February 1, 1976; amended October 23, 1977; December 23, 1979 repealed October 31, 1981.)

[¶ 14-022] .0108 **Due Date of Return. –**

(Added February 1, 1976; amended October 23, 1977; December 23, 1979; repealed October 31, 1981.)

Section .0300 – Computation of Net Income

[¶ 14-035] .0301 **Preliminary Statement. –**

(Added February 1, 1976; amended October 23, 1977; October 4, 1979; January 1, 1980; repealed October 31, 1981.)

[¶ 14-038] .0302 **Adjustments to Federal Taxable Income. –**

(Added February 1, 1976; amended October 23, 1977; October 4, 1979; January 1, 1980; repealed October 31, 1981.)

[¶ 14-041] .0303. **Miscellaneous. –**

(Added February 1, 1976; amended October 23, 1977; October 4, 1979; January 1, 1980; repealed October 31, 1981.)

[¶ 14-044] .0304 **Attribution/Expenses/Nontaxable Income/Nonbusiness Income/Property.** – (a) Direct Expenses – All expenses directly connected with the production of income which is not subject to tax in this State shall be used to compute the net amount of such untaxed income.

(b) Interest Expenses – When a corporation earns income which is not taxed by this State (see examples), or holds property that does or will produce untaxed income, and incurs interest expense which is not specifically related to any particular income or property, it shall attribute a portion of the interest expense to such untaxed income and property in determining taxable income reported to this State. The formula used for computing the amount of interest expense to be attributed to untaxed income and property is as follows:

(1) Value of assets:

* * *

Supreme Court, U.S.
FILED
JUL 6 - 2005
OFFICE OF THE CLERK

(2)

No. 04-1625

IN THE

Supreme Court of the United States

A&F TRADEMARK, INC.; CACIQUECO, INC.; EXPRESSCO, INC.; LANCO, INC.; LERNCO, INC.; LIMCO INVESTMENTS, INC.; LIMTOO, INC.; STRUCTURECO, INC.; AND V. SECRET STORES, INC.,

Petitioners,

v.

E. NORRIS TOLSON, SECRETARY OF REVENUE, STATE OF NORTH CAROLINA,

Respondent.

On Petition For A Writ Of Certiorari To The North Carolina Court Of Appeals

BRIEF AS AMICUS CURIAE SUPPORTING PETITIONER OF THE INTERNATIONAL FRANCHISE ASSOCIATION

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313 S.C. 15, 437 S.E.2d 13, *cert denied*,
510 U.S. 992 (1993) 7, 8

Lanco, Inc. v. Director, Div. of Taxation, 21 N.J. Tax 200
(Tax Ct. 2003) 8

Quill Corp. v. North Dakota ex rel. Heitkamp,
112 S.Ct. 1904 (1992) 7, 8, 10

CONSTITUTION:

U.S. CONST. art. I, §8, cl. 3 4

No. 04-1625

IN THE

Supreme Court of the United States

A&F TRADEMARK, INC.; CACIQUECO, INC.; EXPRESSCO, INC.; LANCO, INC.; LERNCO, INC.; LIMCO INVESTMENTS, INC.; LIMTOO, INC.; STRUCTURECO, INC.; AND V. SECRET STORES, INC.,

Petitioners,

v.

E. NORRIS TOLSON, SECRETARY OF REVENUE, STATE OF NORTH CAROLINA,

Respondent.

On Petition For A Writ Of Certiorari To The North Carolina Court Of Appeals

BRIEF AS AMICUS CURIAE SUPPORTING PETITIONER OF THE INTERNATIONAL FRANCHISE ASSOCIATION

INTEREST OF THE AMICUS CURIAE[1]

Pursuant to Rule 37.2 of the Rules of this Court, the International Franchise Association ("IFA") respectfully submits this brief as *amicus curiae* in support of Petitioner.

[1] No counsel of a party authored this brief in whole or in part, and no person or entity, other than the *amicus curiae* or its members, made a monetary contribution to the preparation or submission of this brief. All parties have consented to the filing of this brief, and the letters of consent of both Petitioners and Respondent have been filed with the Court pursuant to Rule 37.2(a).

Because IFA's members are licensors and licensees of intangible property, IFA has a substantial interest in the outcome of this case and is able to provide an additional and broader perspective on the issues presented. IFA believes this brief will assist the Court in assessing the issues presented by the petition.

IFA is a trade association of more than 1,000 franchising company and 8,000 franchisee members, representing over 75 industries, in many of which franchising is the predominant method of distribution of goods and services. IFA members are franchisors and franchisees of a large majority of the franchised service businesses in the United States. The over 767,000 franchised businesses in the U.S. account for more than one and a half trillion dollars of economic output (about 9.5% of the private-sector economic output). Franchisors and their franchisees directly employ almost 10 million people, and indirectly are responsible for the creation of over 18 million jobs. The largest franchisors have more than 5,000 outlets, the smallest fewer than 10. The great majority of the approximately 2,500 franchisors operating in the United States are small companies, with fewer than 50 franchised outlets. Franchisee members own from one to more than 50 franchised outlets.

Franchising is a successful business relationship. Central to the relationship between a franchisor and its franchisees is a shared trade identity. This shared trade identity is established and maintained by the franchisor's license of its trademark, trade dress and other intellectual property (i.e., intangible property) to each of its franchisees. Thus, each of the hundreds of thousands of franchise relationships that exist in the United States involves a license of intangible property. The great majority of those licenses cross state lines.

Most franchisors own no property in the state in which their franchisees operate, do not maintain offices there and employ no residents of those states. A franchisor's employees may make occasional visits to its franchisee's place of business to assist the franchisee in opening his business and to inspect the franchisee's performance and furnish advice and guidance, but the duration of such visits normally is a few hours or days. The services that a franchisor furnishes to its franchisees, and communication among a franchisor and its franchisees, are implemented almost entirely at the franchisor's principal offices and through interstate communications media. Most franchisors do not rely on the states of their franchisees' domicile for any services and impose no costs on these states.

The franchise relationship has evolved over the last half century with the understanding that the franchisor is not subject to state income taxes (other than those imposed by the franchisor's domicile) on the royalty income paid to the franchisor by franchisees located in a different state. Prior to the late 1980's, with rare exception, the states did not seek to tax such income, unless the franchisor clearly established a traditional nexus by owning or leasing real estate, operating its own outlets, or maintaining an office or employees in the taxing state. The pricing of franchises has developed on the basis that the franchisor's net income will be taxed only by its state of domicile. If every state where a franchisor has granted franchises may tax its income attributable to that state, the franchisor will be subject to costly compliance burdens and overlapping taxes.

Much is at stake for thousands of businesses, franchising companies, their franchisees and other licensors and licensees of intangible property across state lines, in the resolution of the issues presented by Petitioners in their

Petition for Certiorari. Accordingly, this Court should grant the motion of IFA to file an *amicus* brief in support of the petition for certiorari.

SUMMARY OF ARGUMENT

In the decision below, the North Carolina Court of Appeals diminished to the vanishing point the limitations imposed by the Commerce Clause (U.S. CONST. art. I, §8, cl. 3) on the authority of states to impose income taxes on persons engaged in interstate commerce. The court of appeals has held that the mere presence of intangible property satisfies the "substantial nexus" requirement under the Commerce Clause for the imposition of state income tax. This decision radically expands the classes of persons, relationships and transactions potentially subject to state income taxation. The decision has enormous implications for the many thousands of businesses engaged in interstate franchising and licensing of intangible property, a rapidly expanding part of the American economy. If followed, that decision will subject licensors of intangible property in interstate commerce to income taxation by every state in which goods or services exploiting the licensed intangible property are sold. This result will be a radical departure from the historical understanding of the reach of state taxing authority and a significant increase in the tax liabilities and burdens of compliance of thousands of American businesses to an extent that could not have been foreseen. Unless reviewed by this Court, the continuing uncertainty with respect to these issues will impose high costs on companies forced to operate in an environment in which their state tax liabilities are unclear.

The decision below is based on an essentially meaningless test for the Commerce Clause requirement that taxes must be "fairly related to the services provided by the

State" *(Complete Auto Transit, Inc. v. Brady,* 430 U.S. 274, 279 (1977)), by holding that requirement to be met with respect to a licensor, with no physical contact with the taxing state, if the state furnishes services to its licensee operating within the state. Every state tax will pass this test, for every licensee of intangible property will receive some services from the state in which it operates (and for which it pays taxes to the state). The effect of this interpretation of *Complete Auto Transit*, is to write out of the Commerce Clause any meaningful limitations on the authority of states to impose taxes on out-of-state businesses that derive no services from the taxing state, significantly altering the historical understanding of the parameters of state taxing authority. Such taxation is fundamentally unfair, because it permits a state to tax an out-of-state business that imposes no costs on the state and derives no services from the state.

The decision below is based on rationales that greatly expand the constitutional power of states to tax interstate commerce and raise issues of great importance under the Commerce Clause. These issues have enormous significance for a large and growing segment of American business. These are compelling reasons for this Court's review.

ARGUMENT

I. THIS COURT SHOULD DECIDE WHETHER A LICENSED INTANGIBLE PROPERTY THAT IS USED IN A STATE SATISFIES THE NEXUS REQUIREMENTS OF THE COMMERCE CLAUSE

In holding that the mere use of intangible property in a state establishes the requisite constitutional nexus for the state to tax the owner of such property, the Court of Appeals of North Carolina greatly extended the reach of state taxing

authority beyond its historically accepted limits.

The court below concluded that the "substantial nexus" required by the Commerce Clause does not require a physical presence of the taxpayer within the state, merely the presence of the taxpayer's intangible property in the state. The decision, if followed, significantly expands the authority of states to tax thousands of businesses in a broad range of interstate relationships and transactions. Stretched to its logical boundaries, for example, the decision authorizes a state to tax the income of an athlete, who has licensed a sporting goods company to manufacture and sell equipment bearing the athlete's name, solely on the basis that the equipment is sold through retail outlets located in the state. Similarly, the decision permits a state to tax an out-of-state playwright whose copyrighted work is performed in the state. Licensors of intangible property would thus bear state tax burdens that they have not historically borne. If a tax return is not filed, no statute of limitations will limit the period for which taxes, interest and penalties may be due. The alternative, capitulating to the anticipated avalanche of state taxes on income generated by licensors of intangible property, is equally unpalatable and will severely distort the economic relationships of licensors and licensees of intangible property.

The situs of the intangible property of a licensor of such property historically has been considered located in the jurisdiction where its management activities occur, where it receives payment for use of the property, where it negotiates or enters into contracts that generate revenue attributable to the property, or where it performs the activities that create and maintain the value of the property. Such activities may include advertising, product development and testing, and maintaining a disciplined, competitive business system which enhances the value of the licensees' businesses. In

most cases, these activities are performed by the licensor at its principal office, rather than in the locale of a licensee. In many cases, the licensor has no contact with the state of the licensee.

In a typical franchise relationship, the activities a franchisor performs in the franchisee's state are limited to assistance in initially opening the franchisee's business and occasional visits to the franchisee's place of business. The duration of such visits is normally a few hours. The overwhelming majority of the franchisor's activities, as measured by time or value, are performed at the franchisor's principal office and through interstate communications media. To the extent that a franchise generates revenue for the franchisor, those revenues arise from the activities of the franchisor that create and maintain the value of the franchise. The geographic location in which those activities are performed have historically determined the jurisdiction that may properly tax the revenues generated by them.

Unless the physical presence standard established by this Court in *Quill* is clearly applied to state taxes other than sales and use taxes, state tax authorities are likely to assert that the situs of licensed intangible property is in the state where it is used to identify a business, product or service, and taxpayers will contest that assertion, leading to additional litigation.[2] The importance of this issue to

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[2] As noted in Petitioners' brief, pp. 8-11; 16-18, many state courts have addressed the question of the application of this Court's decision in *Quill* to state taxes other than sales and use taxes. Those courts have come down on both sides of the debate, some finding no distinction among different types of state taxes and some holding that *Quill* does not apply to state taxes other than sales and use taxes. Many states continue to assert the right to subject out-of-state companies to income and other nonsales and use taxes, based solely on the presence or use within the state of licensed intangible property. This Court's denial of certiorari in *Geoffrey, Inc. v. South Carolina Tax Comm'n*, 313 S.C.

franchisors and to a broad range of other business relationships built around intangible property is clear. It is critical to those businesses that the Court consider and resolve the application of *Quill* to state taxes other than sales and use taxes and determine whether the use of intangible property within a state meets the Commerce Clause nexus standard.

II. THE DECISION BELOW PERMITS STATE TAXATION OF COMPANIES THAT IMPOSE NO COSTS ON AND RECEIVE NO SERVICES FROM THE TAXING STATE, EMASCULATING THE COMMERCE CLAUSE REQUIREMENTS THAT A STATE TAX MUST BE RELATED TO SERVICES FURNISHED BY THE TAXING STATE

Many licensors of intangible property have no contact with the states where their intangible property is used. Some licensors of intangible property may conduct brief, periodic visits to their licensees. In a great majority of cases, the licensor does not maintain an office or other business location, own any property or employ any residents in the state of its licensee. Accordingly, the licensor derives

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15, 437 S.E.2d 13, *cert. denied*, 510 U.S. 992 (1993), has emboldened many additional states to assert taxing jurisdiction (generally state income or gross receipts taxes) on royalty income and advertising fees paid to the franchisor by in-state franchisees.

The uncertainty among state courts is strikingly illustrated within the opinion by the court, when it refers to the decision of the New Jersey Tax Court in *Lanco, Inc. v. Director, Div. of Taxation*, 21 N.J. Tax 200 (Tax Ct. 2003) (appeal pending), which reached a conclusion opposite to that of the court below in reviewing the business format of the same taxpayer. *A&F Trademark, Inc. v. Tolson*, 605 S.E.2d 187, 195 (N.C. Ct. App. 2004).

no services furnished by the state and local governments of licensees' states and imposes no cost on these states.

This Court made clear in *Complete Auto Transit*, 430 U.S. at 279, that the Commerce Clause mandates that a state tax must be "fairly related to the services provided by the State." The decision of the North Carolina Court of Appeals renders this standard meaningless. If the requisite state-provided services may be benefits provided to the licensee of the intangible property, not to the licensor, the Commerce Clause standard of "fair relationship" has no meaning in interstate licensing relationships. If services furnished to the licensee of intangible property may properly be considered services provided by the state to the licensor, a state can assert that it furnishes services to every person receiving income that at any point in the chain of commerce passed through the hands of its resident. The *Complete Auto Transit* requirement of fair relationship will be satisfied in every case in which a taxing state's resident has earned income from business activity in the state (which is separately taxed by the state), out of which the resident makes a payment to an out-of state licensor. The Commerce Clause requirement that a tax be fairly related to the services provided by the state should not be so easily met.

If the decision of the court below is followed, the Commerce Clause requirement that a state tax be fairly related to services provided by the taxing state will become a test that every state tax will meet in every instance. The effect will be to write an independently significant barrier to taxation of interstate commerce completely out of the law. The decision of the court below would permit state taxation of persons who impose no burdens on and derive no services from the taxing state. Such a change in the law would significantly expand the authority of states to tax the many thousands of businesses engaged in interstate transactions.